OFFICIAL TRANSCRIPT OF PROCEEDINGS BEFORE THE POSTAL RATE COMMISSION

In the Matter of:) Docket No. MC2006-3
WASHINGTON MUTUAL BANK NSA)

VOLUME #3

Date: October 11, 2006

Place: Washington, D.C.

Pages: 255 through 364

HERITAGE REPORTING CORPORATION
Official Reporters
1220 L Street, N.W., Suite 600
Washington, D.C. 20005
(202) 628-4888

POSTAL RATE COMMISSION

In the Matter of:)
) Docket No. MC2006-3
WASHINGTON MUTUAL BANK NSA)

Suite 200
Postal Rate Commission
901 New York Avenue, N.W
Washington, D.C.

Volume 3
Wednesday, October 11, 2006

The above-entitled matter came on for hearing pursuant to notice, at 9:30 a.m.

BEFORE:

HON. GEORGE A. OMAS, CHAIRMAN
HON. DAWN TISDALE, VICE-CHAIRMAN
HON. RUTH Y. GOLDWAY, COMMISSIONER
HON. TONY HAMMOND, COMMISSIONER
HON. MARK ACTON, COMMISSIONER

APPEARANCES:

On behalf of the United States Postal Service:

MATTHEW CONNOLLY, Esquire
FRANK R. HESELTON, Esquire
United States Postal Service
475 L'Enfant Plaza, S.W.
Washington, D.C. 20260
(202) 294-6159/268-5204

APPEARANCES: (cont'd.)

On behalf of the Office of the Consumer Advocate:

EMMETT RAND COSTICH, Esquire
SHELLEY S. DREIFUSS, Esquire
Postal Rate Commission
Office Of Consumer Advocate
901 New York Avenue, N.W., Suite 200
Washington, D.C. 20268
(202) 789-6833

On behalf of Washinston Mutual Bank NSA:

TIMOTHY J. MAY, Esquire
Patton Boggs, LLP
2550 M Street, N.W.
Washington, D.C. 20037-1350
(202) 457-6050

C O N T E N T S

WITNESSES APPEARING:
JAMES F. CALLOW

E X H I B I T S

P R O C E E D I N G S

(9:30 a.m.)

CHAIRMAN OMAS: Good morning. Today we are holding hearings to receive participant's direct testimony in Docket No. MC2006-3, the Postal Service's request for an opinion and recommended decision on a proposed baseline negotiated service agreement with Washington Mutual Bank.

One witness is scheduled to appear today. He is James F. Callow.

The Postal Service has indicated its intent to file surrebuttal testimony in this case. That testimony is due October 19.

Later today I will issue a further schedule ruling. The ruling will set November 9 as the hearing date for the Postal Service surrebuttal. Briefs will be due November 20, and reply briefs will be due December 1.

Does anyone have any procedural matters at this point before we begin?

(No response.)

CHAIRMAN OMAS: Ms. Dreifuss, would you introduce your witness so that I may swear him in?

MR. COSTICH: Mr. Chairman, Rand Costich for the OCA.

CHAIRMAN OMAS: Mr. Costich?
MR. COSTICH: The OCA calls James F. Callow.
CHAIRMAN OMAS: Raise your right hand.
Whereupon,

JAMES F. CALLOW

having been duly sworn, was called as a witness and was examined and testified as follows:
CHAIRMAN OMAS: Please be seated.
Mr. Costich?
MR. COSTICH: Thank you, Mr. Chairman.

(The document referred to was marked for identification as Exhibit No. OCA-T-1.)

DIRECT EXAMINATION

BY MR. COSTICH:
Q Could you state your name for the record?
A James F. Callow.
Q Mr. Callow, do you have before you a document identified as OCA-T-I?
A Yes, I do.
Q What is that document?
A The direct testimony of James F. Callow.
Q Was that testimony prepared by you or under your direction?
A Yes.

Q Do you have any corrections to that testimony?

A No.

Q If you were to testify orally today, would that be your testimony?

A Yes.

MR. COSTICH: Mr. Chairman, I move the admission of the testimony of James F. Callow.

CHAIRMAN OMAS: Is there any objection?

(No response.)

CHAIRMAN OMAS: Hearing none, I will direct counsel to provide the reporter with two copies of the corrected direct testimony of James F. Callow.

That testimony is received into evidence. However, as is our practice, consistent with Commission practice it will not. be transcribed.

(The document referred to, previously identified as Exhibit No. OCA-T-1, was received in evidence.)

CHAIRMAN OMAS: Mr. Callow, have you had an opportunity to examine the packet of designated written cross-examination that was made available to you this morning?

THE WITNESS: Yes, I have.

CHAIRMAN OMAS: If the questions contained in that packet were posed to you orally today, would your answers be the same as those you had previously provided the Commission?

THE WITNESS: Yes. I have, however, four minor word corrections.

In USPS/OCA-T1-4, part (b) and (c), in the second line between the second "as" and "exogenous" insert "other" so that the phrase reads, "...as well as other exogenous factors."

The second minor correction is in USPS/OCA-T1-23, page 2 of the response, part (d-e). Change the first use of the word "factor" -- that would be in line 4 -- to "factors," simply make it plural, so that the phrase reads, "...whateverexogenous factors are identified."

The third minor correction, WMB/OCA-T1-2, page 2, part (d) in line 8. The reference should be to "OCA-T-1" rather than "OCA-T-5," so simply change "5" to "1".

The fourth correction, WMB/OCA-T1-4, page 1 of the response. In the capitalized heading before my written response change "USPS/OCA-T1-4" to WMB/OCA-T1-4". That is it.

CHAIRMAN OMAS: Are there any corrections or additions you would like to make to those answers?

MR. MAY: Mr. Chairman, I am designating WMB/OCA-T1-7, which was filed by OCA yesterday. The witness has the two copies of that response in his packet for the record.

THE WITNESS: Excuse me. I also have filed corrections yesterday to WMB/OCA-T1-1(f), and those corrections are in the packet as well.

CHAIRMAN **OMAS**: Fine. If there are no additional corrections, counsel, would you please provide two copies of the corrected designated written cross-examination of Witness Callow to the reporter?

That material is received into evidence, and it will be transcribed into the record.

(The document referred to was marked for identification as Exhibit No. OCA-T-1 and was received in evidence.)

//
//
//
//
//
//
//

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, DC 20268-0001

Rate and Service Changes to Implement
Baseline Negotiated Service Agreeement
with Washington Mutual Bank

Docket No. MC2006-3

DESIGNATION OF WRITTEN CROSS-EXAMINATION
OF OFFICE OF THE CONSUMER ADVOCATE
WITNESS JAMES F. CALLOW
(OCA-T-1)

Party	Interroqatories
Postal Rate Commission	USPSIOCA-TI-6, 13, 15-16, 25 WMBIOCA-TI-6
United States Postal Service	USPSIOCA-TI-1-5, 7-12, 14, 17-24
Washington Mutual Bank	WMBIOCA-TI-1-5

Respectfully submitted,

Steven W. Williams

Steven W. Williams
Secretary

INTERROGATORY RESPONSES OF
OFFICE OF THE CONSUMER ADVOCATE
WITNESS JAMES F. CALLOW (T-1)
DESIGNATED AS WRITTEN CROSS-EXAMINATION

Interrogatory	Designating Parties
USPSIOCA-TI-1	USPS
USPSIOCA-TI-2	USPS
USPSIOCA-TI-3	USPS
USPSIOCA-TI-4	USPS
USPSIOCA-TI-5	USPS
USPSIOCA-TI-6	PRC
USPSIOCA-TI-7	USPS
USPSIOCA-TI-8	USPS
USPSIOCA-TI-9	USPS
USPSIOCA-TI-10	USPS
USPS/OCA-T1-11	USPS
USPSIOCA-TI-12	USPS
USPSIOCA-TI-13	PRC
USPSIOCA-TI-14	USPS
USPS/OCA-T1-15	PRC
USPSIOCA-TI-16	PRC
USPSIOCA-TI-17	USPS
USPSIOCA-TI-18	USPS
USPSIOCA-TI-19	USPS
USPSIOCA-TI-20	USPS
USPSIOCA-TI-21	USPS
USPSIOCA-TI-22	USPS
USPSIOCA-TI-23	USPS
USPSIOCA-TI-24	USPS
USPSIOCA-T1-25	PRC
WMBIOCA-TI-1	WMB
WMBIOCA-TI-2	WMB
WMBIOCA-TI-3	WMB
WMBIOCA-TI-4	WMB
WMBIOCA-TI-5	WMB
WMBIOCA-TI-6	PRC

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-1-4

USPS/OCA-T1-1

Please refer to page 9, lines 7 and 8, of your testimony You state that "the Washington Mutual NSA, unlike previously proposed or recommended NSAs, permits unlimited discounts."

(a) Please confirm that the term "unlimited discounts" refers to the fact that the Washington Mutual NSA contains no cap or stop loss mechanism in relation to the declining block rate discounts Washington Mutual is eligible to receive If you cannot confirm, please explain.

(b) Please confirm that the NSAs with Capital One, Bank One, and HSBC, as proposed by the Postal Service, did not contain stop loss caps.

RESPONSE TO USPS/OCA-T1-1

(a) Confirmed.

(b) Confirmed. I attempted to capture in a single phrase the fact that the Washington Mutual NSA differs from the "previously recommended" Capital One, Bank One, and HSBC agreements, in which the Commission added a stop loss cap, as well as from the Discover and Bookspan NSAs, which were "previously proposed" (and subsequently recommended) with a stop loss cap.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-1-4

USPS/OCA-T1 -2.

Please refer to the appendix labeled "OCA-T-1_att1 -WMB.xls" that you included with your testimony. Cell D11 in the worksheet tabs labeled "Year 1," "Year 2," and "Year 3" contains the number -0.111483.

a) Please confirm that the source of this number is a coefficient in the multivariate regression model that USPS witness Thress used to forecast demand for First-Class Mail presort letters (Docket No. R2006-1).

b) If you cannot confirm, please explain.

RESPONSE TO USPS/OCA-T1-2

(a) I can confirm that the source of the number -0.111483 is the testimony of Postal Service witness Thress (USPS-T-7), at Table 16, in Docket No. R2006-1.

(b) NA

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-1-4

USPSIOCA-TI-3

Please refer to page 3, lines 10 to 12, of your testimony. You state, "I accept Postal Service witness Ayub's assumption that Washington Mutual's entire discount induced First-class Mail solicitation letter volume is converted from Standard Mail."

a) In your judgment, does Washington Mutual's ability to convert its solicitation letter volume from Standard Mail to First-class Mail suggest that Washington Mutual regards First-class Mail as a close substitute for Standard Mail?

b) Do you agree with the proposition that by substituting a more expensive product (First-class Mail) for a less expensive product (Standard Mail), Washington Mutual expects the additional expense to be offset by a higher response rate to its First-Class Mail solicitations? If no, please explain.

RESPONSE TO USPS/OCA-T1-3

(a) I have no way of knowing how Washington Mutual "regards" First-class Mail vis-a-vis Standard Mail. However, any mailer who voluntarily uses First-class Mail and Standard Mail for essentially the same purposes is behaving as if they are substitutes.

(b) I have no way of knowing what Washington Mutual "expects." However, any mailer who uses a more expensive input for marketing is behaving as if it believes that the substitution will more than pay for itself.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-1-4

USPS/OCA-T1-4

Please refer to page 12, lines 17 to 19, of your testiniony. You state that "Washington Mutual receives discounts on all eligible First-Class Mail solicitation letters exceeding the minimum discount threshold volume of 490 million mailpieces that are prompted for any reason, ensuring Washington Mutual a positive financial outcome."

a) In reaching this conclusion, did you consider whether Washington Mutual's negotiation and litigation costs associated with this NSA would have an effect on Washington Mutual's financial outcome? If yes, please provide the results of your analysis.

b) Do you agree that Washington Mutual's financial outcome under the NSA depends, in part, on the rate of customer responses it receives from its First-Class mail solicitations?

c) If Washington Mutual's solicitation letter volume is converted from Standard Mail to First-class Mail and the rate of customer responses it receives from its First-Class mail solicitations does not increase, will Washington Mutual's financial outcome necessarily be positive? If yes, please explain.

RESPONSE TO USPS/OCA-T1-4

(a) No. The purpose of my testimony was to propose a new financial model to estimate institutional contribution to the Postal Service, the regulated entity.

(b) – (c) Washington Mutual's financial outcome depends in part on customer response rate, as well as other exogenous factors, such as changes in corporate marketing plans. Thus, Washington Mutual's financial outcome may or may not be positive if the rate of customer responses "does not increase." Using the Panzar analysis, I have controlled for exogenous variables in order to estimate the volume response of Washington Mutual to changes in price.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-5-9

USPSIOCA-TI-5.

Please refer to page **25,** lines 11 to 16, and page 26, lines 1 to 3, of your testimony where you estimate the USPS's investment costs, annual administrative costs, negotiation costs, and litigation costs associated with the Washington Mutual NSA.

(a) Please confirm that Washington Mutual Bank will incur similar costs associated with the NSA. If you cannot confirm, please explain.

(b) Have you attempted to estimate or quantify the costs of the NSA to Washington Mutual? If yes, please provide the results of your analysis.

RESPONSE TO USPS/OCA-T1-5

(a) I can confirm that Washington Mutual will incur similar types of costs. However, I do not know whether those costs will be similar in magnitude to the costs incurred by the Postal Service.

(b) No. The purpose of my testimony was to estimate the financial value of the agreement to the Postal Service, the regulated entity.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-5-9

USPS/OCA-T1-6.

Please refer to page 24, lines 17 to 19, of your testimony. You state that "if Washington Mutual mails First-Class Mail solicitation letters exceeding 550 million, 549 million, and 548 million in Years 1, 2, and 3, respectively, the agreement is not worthwhile as a financial proposition."

a) Please confirm that the volume threshold you identify in your testimony for Year 1 of the Washington Mutual NSA is 550 million First-class Mail solicitation pieces. If you cannot confirm, please explain.

b) If Washington Mutual fails to mail more than 550 million First-class Mail solicitation pieces during Year 1 of the agreement, can it be inferred that Washington Mutual will receive no benefit from the NSA? If no, please identify the benefits Washington Mutual may receive under the NSA if it fails to mail more than 550 million First-class Mail solicitation pieces during Year 1 of the agreement.

RESPONSE TO USPS/OCA-T1-6

(a) Not Confirmed. The volume threshold used in the Panzar analysis is 490 million—the same threshold used in the financial model of the Postal Service (see USPS-T-I (Ayub), Appendix A (REV 6-7-06), Page 7). The volume figure of 550 million represents the volume at which the Postal Service will lose First-class Mail contribution in Year 1 of the agreement if Washington Mutual mails total First-class Mail solicitation letters exceeding 550 million.

(b) No. As shown in OCA-T-I, Attachment 'I, if Washington Mutual "fails to mail more than 550 million First-class Mail solicitation pieces" (i.e., Washington Mutual mails First-class Mail solicitation letters greater than 490 million through 550 million) in Year 1 of the agreement, it will receive the "Total Mailer Discounts" in Column [4] associated with the "After Rates Volume (Actual)" shown in Column [2]

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-5-9

USPS/OCA-T1-7

Please refer *to* page 15, lines 14 to 16, of your testimony. You state, "I therefore apply the Panzar analysis to Washington Mutual's forecast volumes utilizing a price-difference, rather than an own-price, elasticity of demand."

a) Please explain the meaning of the term "price-difference elasticity" as you use it in your testimony.

b) Do you agree with the proposition that every individual mailer has a price-difference of elasticity demand of -0.1115? If no, please explain.

c) Did you consider or evaluate the Panzar test using different estimates of price-difference elasticity of demand? If yes, please provide the results of your analysis.

RESPONSE TO USPS/OCA-T1-7

(a) I use the term "price-difference" elasticity as an alternative for the term "discount" elasticity.

(b) No. The price-difference elasticity of -0.1115 is the average response for Standard Mail Regular letters converting to First-class Mail. As such, it is unlikely that any particular mailer would have a price-difference elasticity identical *to* the average.

(c) No.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-5-9

USPSIOCA-TI-8

Please refer to page **16,** lines 8 and 9, of your testimony. You state that neither "the Postal Service nor Washington Mutual, however, supplied a price-difference (or own-price) elasticity specific to Washington Mutual in this proceeding."

a) Did you attempt to estimate Washington Mutual's cross-price elasticity? If yes, please provide the results of your analysis.

b) Did you consider how cross-price elasticity could be used in the development of the Panzar test? If yes, please provide the results of your analysis.

c) If you were to replicate your analysis under the Panzar test using the USPS's average own-price elasticity for First-class Mail and Standard Mail, what would be the results of your analysis?

RESPONSE TO USPSIOCA-TI-8

(a) - (b) No. A cross-price elasticity was not relevant to the development of the Panzar analysis presented in my testimony.

(c) The Postal Service's average own-price elasticity for First-class Mail workshared letters and Standard Mail letters were not relevant to the development of the Panzar analysis presented in my testimony. However, see my response to WMBIOCA-TI-(g), where I use the average First-Class Mail workshared letters own-price elasticity (-0.129934) and the average price-difference elasticity (-0.111483) in the Panzar analysis.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-5-9

USPS/OCA-T1-9

Please refer to page 16, lines 10 to 12, of your testimony. You state, "I use the 'Average Standard Regular Letters Discount (relative to First-class)' developed by witness Thress (USPS-T-7) in Docket No. R2006-1."

a) Please explain why you decided to use the Average Standard Regular Letters Discount for developing the Panzar test.

b) Did you consider using the average First-class Mail and Standard Mail own-price elasticity and cross-price elasticity for developing the Panzar test? If yes, please provide the results of your analysis.

RESPONSE TO USPS/OCA-T1-9

(a) In response to OCA/USPS-T1-25(a) – (c), witness Ayub states that

the relevant elasticities are the own-price elasticity of WMB's First-class Mail and the elasticity of WMB's First-class Mail with respect to the discount between First-class Mail and Standard Mail (rather than the cross-price elasticity).

Witness Ayub further states, in response to OCA/USPS-T1-27, that "Using a discount elasticity[ ] similar to the one used by Witness Thress [USPS-T-7] in Docket No. R2006-1 to model shifts between First-class Presort mail and Standard Mail regular" results in the following equation:

$$Q_0 = Q_1 \cdot \left(\frac{p_0}{p_d}\right)^{E_p} \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

where the term E_d represents "discount elasticity."

However, I assume, like witness Ayub, that Washington Mutual's forecast after-rates volumes are to be derived entirely from the conversion of solicitation letters from Standard Mail to First-class Mail for purposes of estimating the financial value of the agreement. As a result, witness Ayub subsequently confirms, in response to OCA/USPS-T1-29(c), that the form of the equation should be as follows

$$Q_0 = Q_1 \cdot 1 \cdot \left(\frac{d_0}{d'_d} \right)^{E_d}$$

since he implicitly assumes an own-price elasticity of 0 for Washington Mutual's First-Class Mail volume.

Accordingly, the only relevant elasticity to be applied **is** the "discount elasticity," presented in Table 16 of witness Thress' testimony (USPS-T-7), which he identifies as the "Average Standard Regular Letters Discount (relative to First-class)."

(b) No. According to witness Ayub, Washington Mutual's First-class Mail solicitation letters volume is to be derived entirely from the conversion of Standard Mail solicitation letters to First-class Mail. For purposes of estimating the financial value of the agreement, there is no other source for Washington Mutual's First-class Mail volume. Accordingly, I assume an own-price elasticiry of 0. Moreover, as indicated by witness Ayub, a cross-price elasticity is not relevant to the estimation of demand for Washington Mutual,

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-10-16

USPSIOCA-TI-10.

Please refer to page 3, lines 2 to 5, of your testimony. You state, "I propose application of an alternative financial model to the negotiated service agreement concluded between Washington Mutual Bank and the Postal Service, based upon the 'Panzar' analysis presented by the Commission in Docket No. MC2005-3."

a) In developing your Panzar model, did you rely on the framework and guidance presented in the Opinion and Further Recommended Decision of the Postal Rate Commission (PRC) in Docket No. MC2004-3?

b) Did you rely on any additional sources to develop your Panzar model? If yes, please identify those additional sources.

RESPONSE TO USPS/OCA-T1-10

(a) – (b). I relied on the framework and guidance presented in the Opinion and Further Recommended Decision in Docket No. MC2004-3, and additional sources, to the extent cited in my testimony.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-10-16

USPS/OCA-T1-11.

Please refer to page 26 of the PRC's Opinion and Further Recommended Decision in Docket No. MC2004-3 where it states, "The essence of the framework would be for the mailer and the Postal Service to establish a wide range of potential volumes that constituted the realistic bounds of what the mailer would send under the terms of the agreement (afler-rates volumes). The proponents would negotiate a set of discounts that would demonstrably satisfy the Panzar inequality above for every possible after-rates volume within the range."

a) Please confirm that, according to the PRC's Opinion and Further Recommended Decision in Docket No. MC2004-3, the Panzar test requires the proponents to "establish a wide range of potential volumes that constituted the realistic bounds of what the mailer would send under the terms of the agreement (afler-rates volumes)." If you cannot confirm, please explain.

b) In your judgment, what range of volumes would be considered "realistic" as you understand that term?

c) In developing your Panzar model, did you estimate or assume a range of volumes that would be sent under the Washington Mutual NSA? If yes, please state your estimations or assumptions.

d) In your opinion, is it possible to forecast future mail volumes without knowledge of future prices? If yes, please provide examples.

e) In your judgment, did Washington Mutual provide a "realistic" forecast of its before-rates and afler-rates mail volumes in its testimony (WMB-T-I)?

RESPONSE TO USPSIOCA-TI-11

(a) Confirmed.

(b) As stated in PRC Op. MC2005-3, para. 5012, quoted in part a., above, the framework is to be used by "proponents" during negotiations to "establish a wide range of potential volumes." The difference between the framework and the "Panzar" analysis was described by the Commission in PRC Op. MC2005-3 (Bookspan), para. 4089, fn 110:

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-10-16

The Panzar analysis is not to be confused wirh the alternative approach model for designing declining block NSAs suggested by the Commission in its Opinion and Further Recommended Decision in MC2003-4, paras. 5001-38. The former is an analysis for evaluating the risk of loss, while the latter is a model for negotiating NSAs that uses the Panzar analysis in their design.

Since I am not participating in negotiating an NSA. I did not consider what range of volumes would be "realistic."

(c) No.

(d) Yes. A trend analysis has been used in the past by the Postal Service as "a relatively simple approach . . . to predict future movements in mail demand." Docket No. MC2004-3, Revised Declaration of Michael K. Plunkett (May 18, 2005), at 7.

(e) No. I estimated, and the Postal Service confirmed in response to OCA/USPS-T1-29(d), a "discount elasticity" of -0.8538 that was "backed-out" of Washington Mutual's stated before-rates and after-rates point volume estimates using the average revenue for First-class marketing letters, the Standard Mail revenue per piece, and the highest negotiated discount—assuming Washington Mutual's own-price elasticity equals 0. This derived "discount elasticity" is more than 29 Standard Errors away from the "price difference" elasticity developed by witness Thress, calculated as follows: 29.0883 ((0.111483 – 0.85387166) / 0.033187)), where 0.111483 represents the absolute value of the "price difference" elasticity developed by witness Thress, 0.85387166 the absolute value of Washington Mutual's derived "discount elasticity," and 0.033187 the absolute value of the Standard Error developed by witness Thress.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-10-16

USPS/OCA-T1-12

Please refer to pages 24 to 27 of your testimony. On page 25, lines 4 and 5, of your testimony, you state, "I use net present value analysis to estimate the volume that would produce a return on investment equal to the Postal Service's 'cost of money.'"

a) Please confirm that you compared the net present value (NPV) of the Postal Service's costs to the absolute discounts paid to Washington Mutual to estimate the Postal Service's return on investment under the NSA. If you cannot confirm, please explain.

b) To estimate the Postal Service's return on investment under the NSA, did you also compare the NPV of the Postal Service's costs to the NPV value of discounts paid to Washington Mutual?

c) Isn't it true that the comparison described in subpart (b) would yield a more accurate estimate of the Postal Service's return on investment than would the comparison described in subpart (a)? If no, please explain.

RESPONSE TO USPS/OCA-T1-12

(a) Not confirmed. As explained in my testimony in the cited pages, I calculated whether the present values of cash inflows exceed present values of cash outflows discounted at the Postal Service's "cost of money." In the case of the Washington Mutual NSA, cash inflows to the Postal Service consist of "new" contribution, less any discounts "earned" by Washington Mutual. Cash outflows consist of investment expenses (e.g., negotiation and litigation costs), and annual administrative costs. At 544 million in Year 1, the Net Present Value is $49,302—indicating that cash inflows equal (approximately) cash outflows when discounted at the Postal Service's cost of money.

(b) Yes. See the response to part (a), above.

(c) Yes.

RESPONSES *OF* OCA WITNESS JAMES **F.** CALLOW
TO INTERROGATORIES USPS/OCA-T1-10-16

USPSIOCA-TI-I3

Please refer **to** pages 25 and 26 of your testimony. Using the costs you have estimated, pleasecalculate the Postal Service's return on investment under the NSA if the agreement generated the following increases in contribution in Year 1:

a) $1,000,000.

b) $2,000,000.

c) $5,000,000.

RESPONSE TO USPS/OCA-T1-13

The net present value analysis in my testimony is based upon cash inflows during the entire three-year period of the Washington Mutual NSA For purposes of this response, I therefore assume cash inflows of $1 million for Years 1, 2, and 3 in response to part a); $2 million for each year in response to part **b);** and, $5 million for each year in response to part c). I also assume the cash outflows (i.e., negotiation, litigation, and annual administrative costs), and the discount rates of the net present vatue analysis remain the same.

(a) The net present value is: $2,155,116.

(b) The net present value is: $4,853,409.

(c) The net present value is: '$12,946,849.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-10-16

USPS/OCA-T1-14

Please refer to page 11, line 10, of your testimony, where you state that, "Washington Mutual's volume estimates are not subject to replication."

a) Have you attempted to develop independent forecasts of Washington Mutual's before-rates mail volume? If yes, please provide the results of your analysis.

b) Have you attempted to identify exogenous factors that could cause an increase in the before-rates volume?

c) If your answer to subpart (b) is yes, have you attempted to model the impact of these factors on the before-rates and after-rates mail volume? If no, please explain why you have not attempted to do so.

d) Assume that an exogenous factor leads to increased mail volumes. Isn't it true that Washington Mutual would have to spend more money on postage to mail those volumes through the USPS? If no, please explain.

RESPONSE TO USPS/OCA-T1-14

(a) No.

(b) Yes. See my testimony at page 10, lines 1-4.

(c) No. I did not develop a model of Washington Mutual's demand for First-Class Mail solicitation letters to estimate the effect of exogenous factors on Washington Mutual's before-rates and after-rates volume.

(d) Yes. In the context of the Washington Mutual NSA, an exogenous factor (or factors) that increased solicitation letters volume would increase postage revenues to the Postal Service. However, based on the conditions assumed, such an increase in postage would occur with or without the NSA, resulting in the Postal Service receiving an increase in institutional contribution, but not from the NSA.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-10-16

USPSIOCA-TI-15

Please refer to page 7, lines 1 to 5, of your testimony. You state, "An essential requirement of any negotiated service agreement is mutual financial gain for both the Postal Service and the potential NSA partner. Mutual gain arises where the agreement generates additional contribution for the Postal Service resulting from the entry of additional mail in response to discounted rates offered to the participating mailer." Additionally, please refer to page 7, lines **21** and 22. and page **8,** line 1, of your testimony. You state, "A 'win-win' outcome for the Postal Service and the participating mailer is also essential to reduce the risk of harm to mailers not party *to* the agreement, especially where such mailers are dependent on the monopoly services of the Postal Service."

a) Assume that under this NSA Washington Mutual converts all of its Standard Mail volume to First-class Mail resulting in $10 million of increased contribution to the Postal Service.
   I. In your opinion, would Washington Mutual's increased contribution under the *NSA* benefit the Postal Service? **If** no, please explain.
   II. **In** your opinion, would Washington Mutual's increased contribution under the NSA benefit other mailers not party to the agreement? If no, please explain.

b) Additionally, assume that the Postal Service did not enter into this NSA with Washington Mutual. Do you agree with the proposition that the opportunity cost of not pursuing this agreement with Washington Mutual is $10 million? If no, please explain.

c) In your opinion, would the Postal Service be in a better financial position under the hypothetical presented in subpart (a) or under the hypothetical presented in subpart (b)? If no, please explain.

d) In your opinion, would other mailers not party to the agreement be in a better financial position under the hypothetical presented in subpart (a) or under the hypothetical presented in subpart (b)? If no, please explain.

RESPONSE TO USPSIOCA-TI-15

(a) – (d) I don't know. Washington Mutual may convert its Standard Mail to First-class Mail because of exogenous factors, with or without the NSA.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-10-16

USPSIOCA-TI-16

Please refer to page 28, lines 2 to 6, of your testimony. You state in part, "This expected contribution is sufficient to recover the Postal Service's investment in the Washington Mutual NSA. and provide a meaningful contribution to institutional costs."

a) Please explain what you mean by the phrase "meaningful contribution to institutional costs" as you use it in your testimony.

b) Have you identified a minimum absolute value of increased contribution that will "provide a meaningful contribution to institutional costs"? If yes, please provide the analysis used to develop this number.

RESPONSE TO USPS/OCA-T1-16

(a) I define the phrase "meaningful contribution" to mean institutional contribution to the Postal Service significantly greater than $0.

(b) Yes. At a volume of 521 million, the estimated financial benefit to Washington Mutual approximates the expected contribution received by the Postal Service during the three-year period of the agreement. The Postal Service's expected contribution is $3.453 million, while Washington Mulual "earns" discounts of $3.510 million. See my testimony at pages 27-28. At this volume, contribution to the Postal Service is approximately 100 percent, i.e., 98.4 percent ($3.454 / $3.510) of Washington Mutual's discounts, and therefore provides a "meaningful contribution to institutional costs."

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-17-18

USPS/OCA-T1-17.

On page 24, lines 22 to 24, of your testimony, you state, "The Panzar analysis does not consider the Postal Service's...costs of litigation to obtain regulatory approval."

a) To your knowledge, has the Postal Rate Commission ever considered a party's costs of litigation to obtain regulatory approval in a rate and classification proceeding? If yes, please provide examples.

b) Please confirm that, as a general matter, the USPS's NSA litigation and negotiation costs are likely to increase when an intervenor files testimony. If you cannot confirm, please explain.

c) Please confirm that, as a general matter, the USPS's NSA litigation and negotiation costs are likely to increase when the Commission alters the terms of the NSA. If you cannot confirm, please explain.

RESPONSE TO USPSIOCA-TI-17.

(a) Not to my knowledge. That said, while a negotiated service agreement is presented in a mail classification proceeding, it is not a "typical" mail classification. In a "typical" mail classification proceeding, the Postal Service proposes a cost coverage that includes a reasonable contribution to institutional costs based upon the rates and fees in its request to the Commission. Under such circumstances, litigation costs are considered at least indirectly by the Commission in determining the appropriate cost coverage. Unlike "typical" mail classification proceedings, however, the Postal Service does not propose a cost coverage based upon the discounted rates contained in a negotiated service agreement. To date, negotiated rates have simply been required to generate an estimated increase in institutional contribution to the Postal Service greater than $0 for the agreement as a whole. The net present value analysis I propose attempts to establish a reasonable basis for estimating at what point the Washington

Mutual NSA will make a reasonable contribution to the institutional costs of the Postal Service. As suggested by the Commission in PRC Op. MC2005, paras. 4014, fn 50, and 4015, fn 51, I propose a positive return on the Postal Service's investment at least equal to the Postal Service's "cost of money."

(b) – **(c)** In general, litigation expenses are likely to increase in response to intervenor testimony or Commission action. However, litigation associated with active participation by an intervenor or Commission action is a cost to obtain regulatory approval and, as such, that cost should be included in any estimate of litigation expenses. By contrast, negotiation expenses would be relatively fixed in amount as they are associated with developing and concluding an agreement, and for the most part occur prior to litigation before the Commission.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-17-18

USPS/OCA-T1-18.

Please refer to page 25, lines 15 and 16, and page 26, line 1, of your testimony. You state, "I estimate the Postal Service's investment in negotiating and litigating the Washington Mutual NSA at $250,000 each.. .or $500,000."

a) Please provide the quantitative analysis on which you relied to develop this estimate.

b) Please confirm that you used either the penalty figure from section II(J) of the Washington Mutual NSA ("Solicitation Mail Volume Guarantee") or the penalty figure from section III(D) of the agreement as a proxy for your estimate of the USPS's costs for negotiating and litigating the agreement. If you cannot confirm, please explain.

c) Please confirm that, to your knowledge, the USPS has never represented that either of the penalty figures referenced in subpart (b) serves as a proxy for the USPS's costs for negotiating and litigating the agreement. If you cannot confirm, please explain.

RESPONSE TO USPS/OCA-T1-18.

(a) See my response to WMB/OCA-T1-4(a) – (b) for the basis of my estimate of the costs of negotiation. See my response to part (c), below, for the basis of my estimate of litigation costs.

(b) Confirmed, for the Postal Service's costs of litigation.

(c) I interpreted the testimony of witness Ayub on oral cross-examination to mean the litigation costs of the Postal Service:

> I think [the transaction penalty cost of $250,0001 is supposed to cover the transaction costs of pursuing the NSAs. Tr. 2/184

USPSIOCA-TI-19.

Please refer to your response to USPSIOCA-TI -5, subpart (b), where you confirm that you have not attempted to quantify the cost of the NSA to Washington Mutual. Please also refer to page 7, lines 9 to 10, of your testimony. You state, "An essential requirement of any negotiated service agreement is mutual financial gain for both the Postal Service and the potential NSA partner."

a) Please confirm that Washington Mutual Bank would benefit financially from the incentives the NSA will provide WMB for converting Standard Mail volume to First-class Mail.

b) In your judgment, is it possible to determine whether the WMB NSA will result in "mutual financial gain" to WMB and the Postal Service without attempting to quantify the costs of the agreement to WMB? If yes, please explain.

RESPONSE TO USPSIOCA-TI-19.

(a) Confirmed, assuming Washington Mutual enters "eligible" First-class Mail, as that term is defined under the NSA.

(b) Yes. Quantifying the financial gain to Washington Mutual under the NSA has not been estimated by the Postal Service, or provided by Washington Mutual. Moreover, the Commission has not prepared, or required the Postal Service or NSA participants to provide, an estimate of financial gain. Nor in my judgment is it necessary in order to determine whether Washington Mutual will derive any financial gain. Since Washington Mutual can exit the agreement "without cause" at any time, expected financial gain to Washington Mutual is signified by its continued participation in this proceeding.

USPSIOCA-TI-20.

Please refer to your response to USPS/OCA-T1-4, subparts (b) and (c). You state, "Washington Mutual's financial outcome may or may not be positive if the rate of customer responses 'does not increase.'" Please assume for the purpose of this interrogatory that the NSA induces WMB to shift 90 percent of its solicitation mail volume to First-class Mail from Standard Mail. Additionally, please assume that all other variables remain constant except for the rate of customer responses WMB receives from its First-class Mail solicitations.

a) If the customer response rate referenced above were to decrease or remain constant after WMB converts its Standard Mail volume to First-class Mail, could WMB experience a net positive financial outcome under the NSA?

b) If the answer to subpart (a) is "yes," please explain how WMB could experience a net positive financial outcome under the NSA.

c) Does the possibility that WMB's customer response rate might decrease under the NSA pose a financial risk to WMB?

d) If your answer is to subpart (c) is "no" please identify any risks you have identified for WMB under the NSA.

RESPONSE TO USPS/OCA-T1-20.

(a) - (b) The Postal Service has selected one exogenous factor—the response rate of customers receiving Washington Mutual's solicitation letters—and assumed that rate will decrease or remain constant for First-class Mail solicitation letters after implementation of the NSA. This is implausible in that the decrease in response rate is assumed to be present only after-rates, but not before-rates. Moreover, while customer response rates may differ as between First-class Mail and Standard Mail, any exogenous factor that affects the response rate of customers receiving First-class Mail solicitations will also affect the response rate of customers receiving Standard Mail solicitations in the same direction. Given the implausible nature of this interrogatory's assumption, Washington Mutual is unlikely to experience a net positive financial outcome.

(c) - (d) The Postal Service's assumed risk—that the customer response rate might decrease—is not a financial risk inherent to or associated with an NSA. The risk that Washington Mutual (or the Postal Service) may misestimate the customer response rate, or the risk of any other exogenous factor, is always present and is independent of whether Washington Mutual participates in an NSA or not. Thus, the Commission's statement regarding risk is accurate:

> All risk related to volume forecasts used as the basis for unrestricted volume discounts is borne by the Postal Service and other mailers not party to the agreement. PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), para. 5007, fn 21.

Moreover, for purposes of estimating the financial value of the agreement, I explicitly controlled for the effects of exogenous factors before-rates and after-rates in developing the Panzar analysis. Doing so precludes manipulation of exogenous factors to produce a desired or intended outcome, such as an assumption of the presence of exogenous factors after-rates, or the lack thereof, that differs from before-rates, or vice versa. As a result, the Panzar analysis produces an estimate of financial value that is based on volumes attributable to the discounted rates, rather than to exogenous factors. The Postal Service's hypothetical is not a *ceteris paribus* assumption, since the customer response rate is assumed relatively unfavorable to Washington Mutual after-rates, but relatively favorable before-rates.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-19-25

USPS/OCA-T1-21.

Please refer to your response to USPSIOCA-TI -8, subparts (a)-(b), where you state that "A cross-price elasticity was not relevant to the development of the Panzar analysis presented in my testimony."

a) Please define the term "cross-price elasticity" as you understand it.

b) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB and that all exogenous factors and postage prices remain constant. Additionally, please assume that WMB converts its Standard Mail volume **to** First-class Mail at the rate identified in the original filing. Please calculate the resulting cross-price elasticity and explain how you reached your result.

c) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB and that all exogenous factors and postage prices remain constant. Additionally, please assume that WMB converts its Standard Mail volume to First-class Mail at the rate identified in the original filing. Please confirm that a calculation of cross-price elasticity would be essential to an evaluation of WMB's mailing preferences. **if** you cannot confirm, please explain.

RESPONSE TO USPSIOCA-TI-21.

(a) A "cross-price'' elasticity, or a cross elasticity of demand, "measures how sensitive [ ] purchases of *one* product (say X) are to a change in the price of some *other* product (say Y)." (Emphasis original). McConnell, Campbell R., *Economics* (10th Ed., 1987), 502. In general terms, a cross elasticity of demand can be described as follows:

$$E_{xy} = \frac{\text{Percentage Change in } \underline{\text{Quantitv Demanded of X}}}{\text{Percentage Change in Price of } Y}$$

More specifically, the cross-elasticity of demand is "the percentage change in the quantity of *X* purchased resulting from a 1 percent change in the price of *Y*." Ferguson,

C. E., Microeconomic Theory, (1969), 86. Thus, the cross-elasticity of demand can be defined as:

$$E_{xy} = \frac{\Delta q_x}{q_x} \div \frac{\Delta p_y}{p_y}$$

where E_{xy} is the cross elasticity of demand for product x with respect to a change in price of product y, Δq_x is the change in the quantity of x, and Δp_y is the change in the price of y.

(b) – (c) The purpose of my testimony is to estimate the financial value of the Washington Mutual NSA to the Postal Service. The hypothetical is unrelated to my testimony in that it requests the calculation of a cross elasticity under circumstances where there is no agreement. Specifically, the hypothetical assumes "the Postal Service does not enter into an NSA with WMB and that *all* . . . postage prices remain constant." (Emphasis added).

In order to estimate the financial value of the agreement, I did not consider the possibility of no agreement. Nor did I calculate a cross elasticity, or consider the role of such an elasticity in any evaluation of Washington Mutual's mailing preferences. In addition, as stated previously, a cross elasticity is not relevant to the development of the Panzar analysis in my testimony.

Moreover, the hypothetical cannot be answered as posited. Given the absence of any change in the price of First-class Mail or Standard Mail, as stated in the hypothetical, the requested cross elasticity cannot be derived because the definition of a cross elasticity (see part (a), above) requires a change in price.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-19-25

USPSIOCA-TI-22.

Please refer to your response to USPSIOCA-TI -11, subpart (d), where you confirm that it is possible to forecast future mail volumes without knowledge of future prices. Additionally, you state that "A trend analysis has been used in the past by the Postal Service 'as a relatively simple approach...to predict future movements in mail demand.'"

a) Please confirm that it is your understanding that the Postal Service uses trend analysis to forecast before-rates or after-rates mail volume.

b) In your judgment, do you believe that a trend analysis which does not account for price changes can yield an accurate estimate of future mail volumes?

c) Is the price of postage an important factor in developing a forecast of demand?

d) To your knowledge, are there any other methodologies other than a trend analysis that would enable USPS or WMB to forecast future mail volume?

RESPONSE TO USPS/OCA-T1-22.

(a) Confirmed.

(b) In my judgment, a trend analysis that forecasts future mail volumes solely as a function of time does not account for price changes, and therefore cannot yield a reliable or accurate estimate of future mail volumes. The Postal Service apparently agrees, stating that "a simplified trend analysis ignores exogenous factors such as pricing changes, interest rates . . . competitors' strategies . . . and a host of other variables." Docket No. MC2004-3, Revised Declaration of Michael K. Plunkett (May 18, 2005), at 8.

(c) Yes.

(d) I don't know. To the extent there are, I did not consider them, and they are not used in my testimony. That said, the use of price elasticities is one methodology I am aware of that explicitly controls for the effects of exogenous variables in estimating future mail volumes. In my testimony, I used a price-difference elasticity.

USPS/OCA-T1-23.

Please refer to your response to USPS/OCA-T1 -11, subpart (e). Additionally, please refer to your response to USPS/OCA-T1-14, subpart (c) where you state, "I did not develop a model of Washington Mutual's demand for First- Class Mail solicitation letters to estimate the effects of exogenous factors on Washington Mutual's before-rates and after-rates volume."

a) Please confirm that your response to USPS/OCA-T1-11, subpart (e), is based solely on an evaluation of Washington Mutual's before-rates and after-rates volumes and the elasticities you identified in your response to USPS/OCA-T1 -11, subpart (e).

b) Please describe all factors other than the elasticities you identified in your answer to USPS/OCA-T1 -11, subpart (e), that support your negative response to USPS/OCA-T1-11, subpart (e).

c) Please identify the exogenous factor or factors that might cause WMB to shift its solicitation mail volume from Standard Mail to First-class Mail.

d) For the purpose of this subpart, please assume that the Postal Service does not enter into an NSA with WMB. For each factor identified in subpart (c) please describe how these factors would induce WMB to shift its solicitation mail volume from Standard Mail to First-class Mail.

e) Please confirm that you did, not independently estimate the effect of exogenous factors on Washington Mutual's before-rates and after-rates mail volumes.

f) In your judgment, is it possible to estimate the impact a change in an exogenous factor would have on mail volume without also estimating the effect of exogenous factors on before-rates and after-rates mail volumes? If your answer is yes, please explain.

RESPONSE TO USPS/OCA-T1-23.

(a) Confirmed.

(b) I considered none.

(c) In my testimony, I listed a few exogenous factors from an infinite number of possible factors that might cause a shift in Washington Mutual solicitation mail volume.

Probably the most important factors "include changes in corporate management, or changes in corporate financial goals or marketing strategies." See my testimony at page **10,** lines 1-4.

(d) - (e) I did not independently model the effects of exogenous factors on Washington Mutual's mail volumes. Consequently, I do not know with certainty how Washington Mutual would respond to these exogenous factors. Nevertheless, whatever exogenous factors are identified, those factors will be present and affect Washington Mutual's mail volumes with or without the NSA. Most problematic for the Postal Service, however, would be a change in corporate marketing strategy in which Washington Mutual decided to shift its solicitation mail volume from Standard Mail to First-class Mail, and then concluded with the Postal Service a negotiated service agreement that featured discounted rates.

(f) No. As witness Ayub has testified, "If a variable causes a change in the before-rates forecast, holding all other factors equal, it should have a similar impact in the same direction on the after-rates forecast." Tr. 2/28 (OCA/USPS-T1-1(d)).

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPSIOCA-TI-19-25

USPSIOCA-TI-24.

Please refer to your response to USPSIOCA-TI-15, subparts (a) - (d), where you state, "I don't know. Washington Mutual may convert its Standard Mail to First-class Mail because of exogenous factors, with or without the NSA." Please revise your responses to USPSIOCA-TI-15, subparts (a) - (d), assuming that all exogenous factors remain constant.

RESPONSE TO USPSIOCA-TI-24.

In my response to USPS/OCA-T1-15(a) - (d), assumed that all exogenous factors remain constant because such factors are ah ays present and may cause Washington Mutual to convert its Standard Mail to First-class Mail, "with or without the NSA." Thus, my answer remains the same.

Interrogatory USPSIOCA-TI-15(a) - (d) assumes that the Postal Service will automatically benefit from an NSA if, after the agreement is implemented, there is a subsequent increase in mail volume. However, it cannot be assumed that because the Postal Service enters into an NSA with a mailer and volumes increase that the increase was caused by the NSA. In doing so, the Postal Service commits **the** well known logical fallacy *post* hoc ergo propfer hoc. It is entirely possible that the increase in mail volume was caused by exogenous factors, which exist with or without the NSA. Moreover, increased contribution benefiting the Postal Service and mailers not party to the agreement, above what would be realized absent a NSA, occurs only where additional mail volume is caused by the incentive to mail additional volume (because of the mailer's demand characteristics), and not because of exogenous factors.

RESPONSES OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES USPS/OCA-T1-19-25

USPS/OCA-T1-25.

Please refer to your response to USPS/OCA-T1-16, subpart (a), where you state, "I define the phrase 'meaningful contribution' to mean institutional contribution to the Postal Service significantly greater than $0." Please define the threshold for "significantly greater than $0."

RESPONSE TO USPS/OCA-T1-25.

At a "threshold" (i.e., volume) of 521 million during each year of the agreement, the resulting institutional contribution of $3.453 million would represent a "meaningful contribution" to the Postal Service "significantly greater than $0." See my response to USPS/OCA-T1-16(b).

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMBIOCA-TI-1-4

WMBIOCA-TI-1

Please refer to lines 6 through 12 on page 16 of your testimony where you state:

> Neither the Postal Service nor Washington Mutual, however, supplied a price-difference (or own-price) elasticity specific to Washington Mutual in this proceeding. In the absence of such a company-specific elasticity, I use the "Average Standard Regular Letter Discount (relative to First-class)" developed by witness Thress (USPS-T-7) in Docket No. R2006-1. That elasticity, estimated at -0.1115, serves by default as a proxy for Washington Mutual's elasticity of demand for Standard Mail with respect to the change in the price difference between First-class Mail and Standard Mail.

Please also refer to witness Ayub's response to OCA/USPS-T1-29(d) where he confirms that "if Washington Mutual's First-class mail volume had an own-price elasticity of demand equaling zero, the given equation could be solved as stated, within rounding" in response to OCA's calculation of a -.8538 "discount elasticity" for WMB's First-class Mail volume.

Further, please refer to page 18 of your testimony where you discuss the volume above which the Panzar analysis indicates that "the Postal Service will lose First-class Mail contribution in Year 1 of the agreement."

Finally, please refer to the elasticities for workshared First-class Mail presented on page 73 of witness Thress' testimony (USPS-T-7) in Docket No. R2006-1.

(a) Please confirm that the Panzar analysis presented in your testimony assumes that the own-price elasticity of demand of WMB's First-class Mail volume is zero. If not confirmed, please explain fully.

(b) Please confirm that the Panzar analysis presented in your testimony does not take into account any cost savings from the NSA. If not confirmed, please explain fully.

(c) Please confirm that the Panzar analysis in your testimony assumes that WMB's "price-difference elasticity" is equal to the average for workshared First-class Mail, but that its own-price elasticity is significantly less - zero - than the average for workshared First-class Mail. If not confirmed, please explain fully.

(d) Please confirm that the volume above which the Panzar analysis estimates "the Postal Service will lose First-class Mail contribution" would be higher than presented in your testimony if it used average elasticities (for workshared First-Class Mail) for both the price difference elasticity and the own-price elasticity. If not confirmed, please explain fully.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIESWMBIOCA-TI-1-4

(e) Please confirm that the volume above which the Panzar analysis estimates "the Postal Service will lose First-class Mail contribution" would be higher than presented in your testimony if it used the price-difference elasticity of-,8538 that OCA calculated in OCA/USPS-T1-29(d) and an own-price elasticity of zero. If not confirmed, please explain fully.

(f) Please provide revisions to Figures 1, 2, and 3 of your testimony based upon a Panzar analysis that uses a price-difference elasticity of-.8538 and an own-price elasticity of zero, Please also provide all of your underlying calculations in an electronic spreadsheet format.

(g) Please provide revisions to Figures 1, 2, and 3 of your testimony based upon a Panzar analysis that uses the average price-difference and own-price elasticities for workshared First-class Mail. Please also provide all of your underlying calculations in an electronic spreadsheet format.

RESPONSE TO WMB/OCA-T1-1

(a) Confirmed

(b) Confirmed. Consistent with the financial model of the Postal Service, I do not assume any cost savings from the provision of electronic address correction notices in lieu of physical returns in estimating the financial value of the Washington Mutual NSA using the Panzar analysis.

(c) Confirmed.

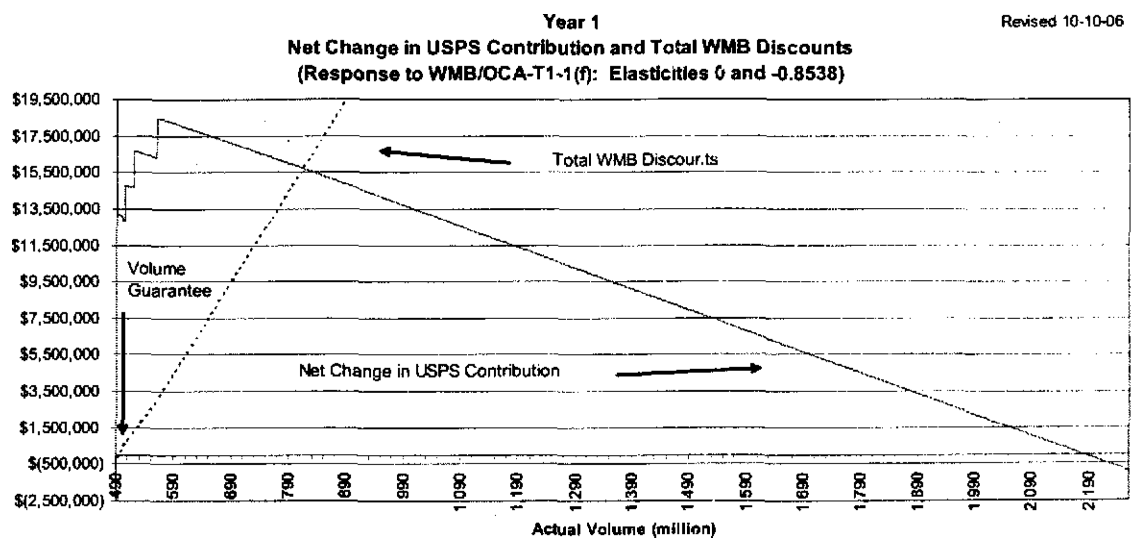
(d) Confirmed. Based upon the Panzar analysis using the average First-class Mail workshared letters own-price elasticity and the average price-discount elasticity, if Washington Mutual mails First-class Mail solicitation letters exceeding 585 million, 584 million, and 582 million in Years 1, 2, and 3, respectively, the Postal Service will lose First-class Mail contribution. See response to part (g), below.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4

Revised 10-10-06

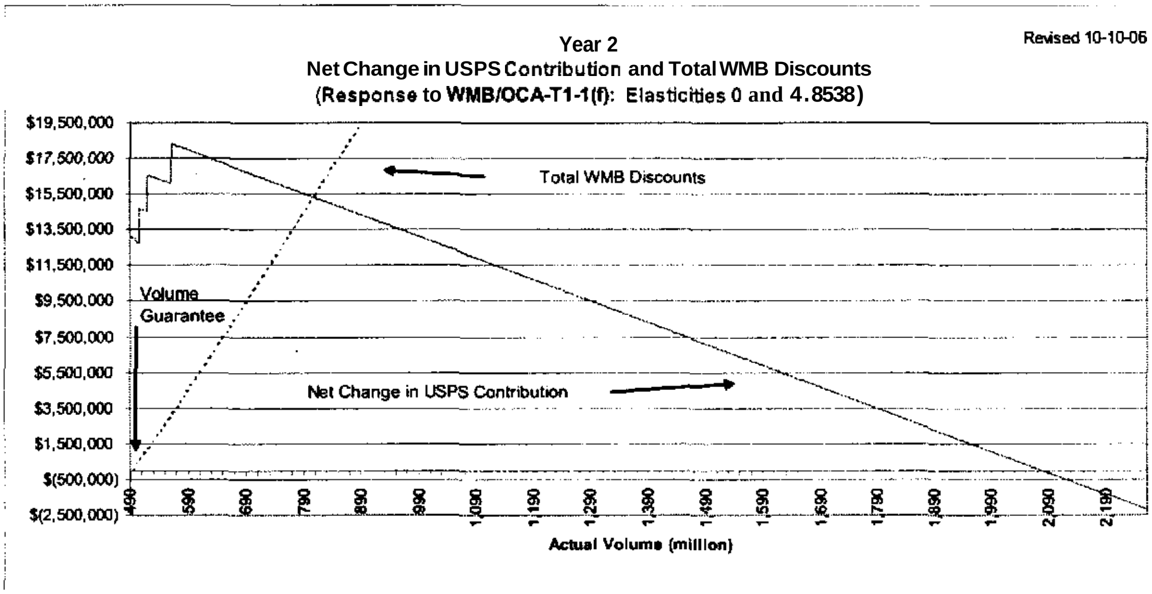
(e) Confirmed. The price-difference elasticity of -0.8538 was "backed-out" of Washington Mutual's stated before-rates and after-rates point volume estimates, using the average revenue for First-class marketing letters of $0.324, the Standard Mail revenue per piece of $0.204, and the highest negotiated discount of $0.050

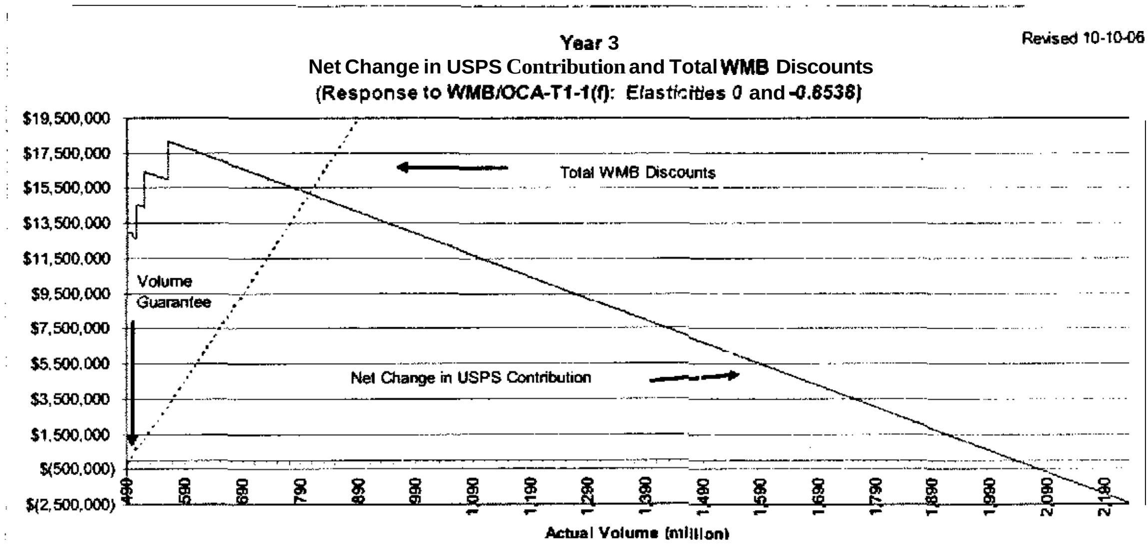
(f) See charts for Years 1, 2, and 3, below, developed by inserting -0.8538 in Cell D11 of the Excel file **"Resp(REV10-10-06)_WMB/OCA-T1-1(f).xls,"** worksheets "Year 1," "Year 2," and "Year **3."** The First-class Mail and Standard Mail revenue figures used to derive the price-difference elasticity of -0.8538 are provided in response to part (e), above. This respohse also uses the First-class Mail marketing letter and Standard Mail unit costs provided in the testimony of witness Ayub (USPS-T-1). as originally filed, to calculate the institutional contribution used to develop the charts See USPS-T-1 (Ayub). Appendix A, Page 10.



**ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMBIOCA-TI-1-4**

Revised 10-10-06

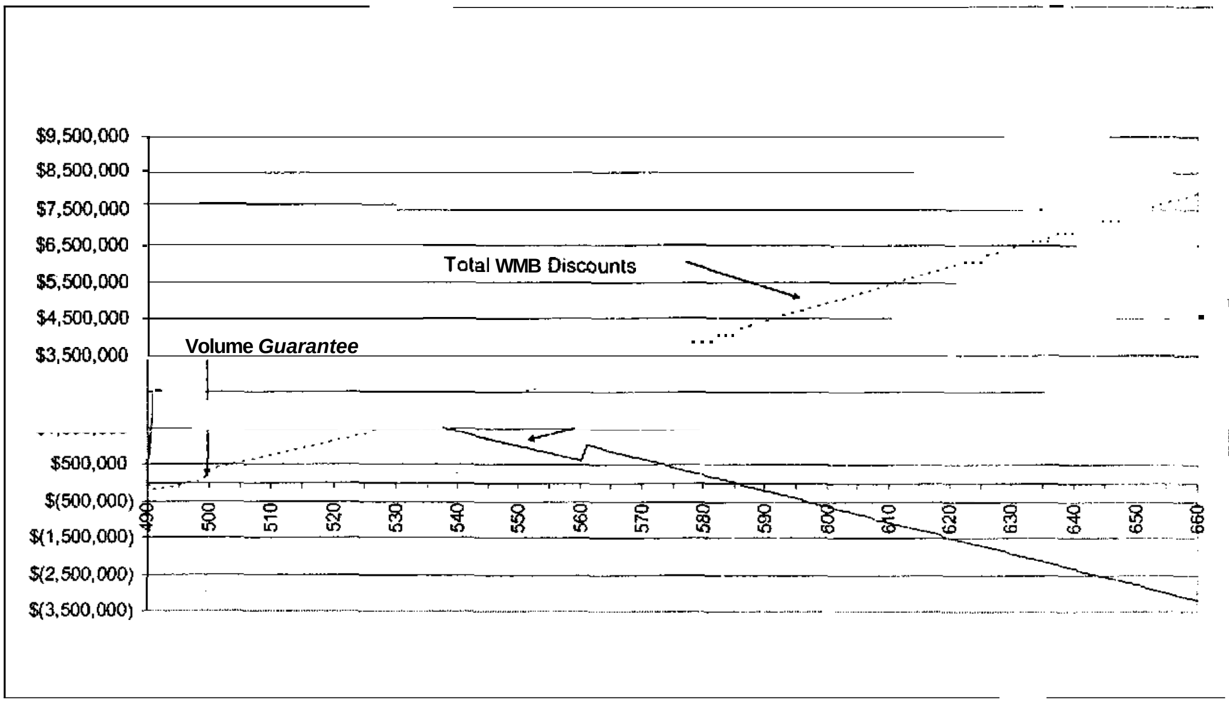




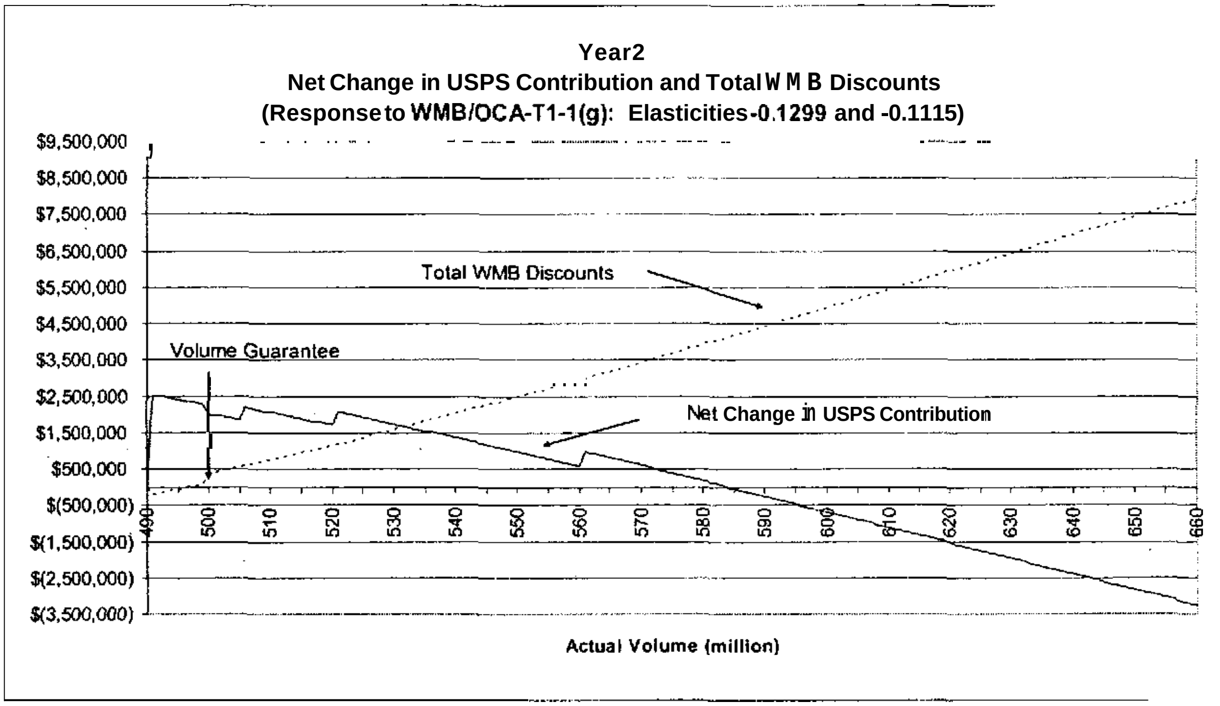
(g) See charts, below, for Years 1, 2, and 3, obtained by using the "Long-Run" own-price elasticity (-0.129934) for First-class workshared letters estimated by witness Thress (USPS-T-7), Table 16, in Docket No. R2006-1, and the average price-difference elasticity (-0.111483) in the following equation

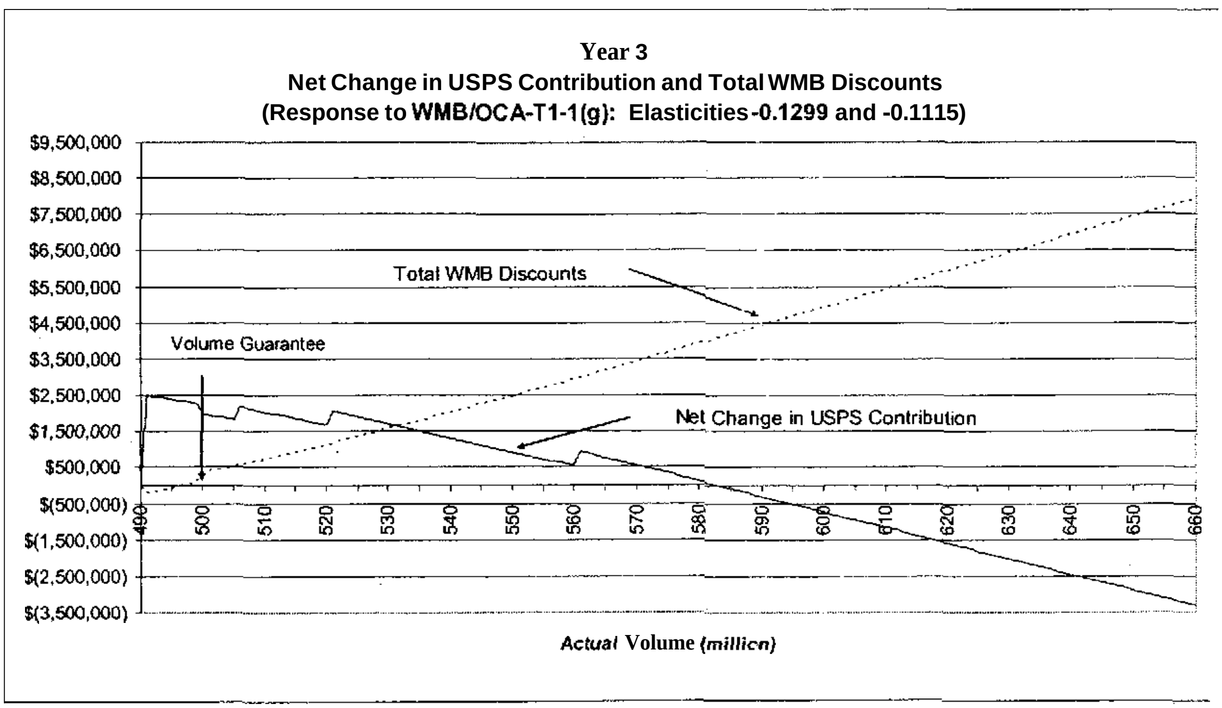
$$Q_0 = Q_1 \cdot \left(\frac{p_0}{p_d}\right)^{E_p} \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

where Q_0 is the before-rates Standard Mail volume, Q_1 is the forecast after-rates First-Class Mail volume, p_0 is the before-rates average First-class Mail marginal price, p_1 is the after-rates average marginal price, E_p is the average First-class workshared letters own-price elasticity, d_0 is the before-rates average marginal price difference between First-class Mail and Standard Mail, d_1 is the after-rates average marginal difference, and E_d is the price-difference elasticity.



ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4





ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4

WMB/OCA-T1-2.

Please refer to page 80 of the Commission's Docket No. MC2005-3 Opinion and Recommended Decision where it states, "the Panzar test does not tell the whole story here since it does not take into account the potential aenefits from the conversion of flats to letters or the positive benefits from Bookspan's unique multiplier effect." Please also refer to page 31 of witness Ayub's testimony.

a) Please confirm that the Postal Service estimates that the WMB NSA will generate cost savings. If not confirmed, please explain fully.

b) Please confirm that the Panzar test "does not tell the whole story" in the WMB NSA because it does not take into account these cost savings. If not confirmed, please explain fully.

c) Please confirm that, in the Bookspan NSA, the Commission did, at least qualitatively, take into account potential benefits from the NSA that are not accounted for in the Panzar test. If not confirmed, please explain fully.

d) Please explain fully how you believe the cost savings from the WMB NSA should be taken into account.

RESPONSE TO WMB/OCA-T1-2

(a) Confirmed that the Washington Mutual NSA will generate a cost saving associated with providing electronic address correction notices in lieu of physical returns, according to the Postal Service. However, those cost savings are not included in the Postal Service's estimate of the financial value of the Washington Mutual agreement.

(b) Confirmed that neither the Panzar analysis nor the Postal Service's financial model "tell[s] the whole story" since neither model takes into account cost savings from the provision of electronic address correction notices in lieu of physical returns.

(c) Confirmed that the Commission qualitatively took into account the potential benefits of Bookspan's multiplier effect. In the absence of an estimate of the financial value of the multiplier effect, it is not possible to account for any potential benefits using the Panzar analysis. Assuming an estimate of the financial value of Bookspan's multiplier effect were available, that value could have been incorporated into the Panzar analysis as described in part (d), below.

(d) Consistent with the financial model of the Postal Service, I do not assume any cost savings from the provision of electronic address correction notices in lieu of physical returns in estimating the financial value of the Washington Mutual NSA using the Panzar analysis. However, those cost savings, estimated at $2.2 million, $2.4 million, and $2.7 million in Years 1, 2 and 3, respectively, could be incorporated into the Panzar analysis as follows. For any assumed actual after-rates volume, the estimated cost savings for each year would be added *to* the "Net USPS Benefits" (Column [3] in OCA-T-1, Attachment 1) associated with the assumed actual volume for that year to estimate total value (i.e., net revenue plus cost savings) to the Postal Service. For example, the estimate of total value to the Postal Service in Year 1 assuming an actual volume of 521 million would be $3,380,663, consisting of $1,180,663 in "Net USPS Benefit" and $2,200,000 in cost savings.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4

WMB/OCA-T1-3

Please refer to Table 1 on Page 25 of your testimony, which presents your analysis of the Net Present Value of the Washington Mutual NSA.

a) Has the Commission required the net contribution of previously approved NSAs to cover negotiation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

b) Has the Commission required the net contribution of previously approved NSAs to cover litigation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

c) Has the Commission required the net contribution of previously approved NSAs to cover administrative costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

d) Has the Commission required the net contribution of previously approved niche classifications to cover litigation costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

e) Has the Commission required the net contribution of previously approved niche classifications to cover administrative costs? If so, please provide references to where the Commission in its previous Opinions and Recommended Decisions has required this.

9 Are the administrative, litigation, and negotiation costs shown in Table 1 institutional costs or attributable costs according to USPS costing methods? Please explain your response fully.

g) Are the administrative, litigation, and negotiation costs shown in Table 1 institutional costs or attributable costs according to PRC costing methods? Please explain your response fully.

RESPONSE TO WMB/OCA-T1-3

(a) – (c) No. That said, one of the purposes of my testimony is to ask the Commission to determine whether the Washington Mutual agreement should produce a positive return on investment, using net present value analysis, considering the Postal Service's investment in negotiating and litigating the agreement, and the estimated annual administrative expenses.

(d) – (e) While the Commission has not specifically estimated the litigation or administrative costs associated with a niche classification, or required that those costs be covered by revenues generated from a previously approved niche classification, there is an essential difference between an NSA and a niche classification. For a niche (or any other) mail classification, the Commission sets rates sufficient to cover attributable costs ***and*** make a reasonable contribution to the Postal Service's institutional costs, which include litigation and administrative costs. The resulting cost coverage may cover all or part of these institutional costs associated with the niche classification. In any event, it is clear these costs are considered at least indirectly by the Commission in determining the appropriate cost coverage for the niche classification. In the case of NSAs, negotiation, litigation and administrative expenses are not considered at all because neither the Postal Service nor the Commission has established an appropriate "cost coverage," or specified a positive rate of return for NSAs.

(f) Under the Postal Service's costing methodology, negotiation, litigation, and administrative costs associated with an NSA would be considered incremental costs.

Consequently, the Postal Service's markup would be expected to cover volume variable as well as incremental costs.

(g) Under the Commission's costing methodology, negotiation, litigation, and administrative costs associated with an NSA would also be considered incremental costs. In setting rates, the Commission would be expected to add incremental costs to volume variable costs, for which an appropriate markup would be made.

ANSWERS OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORIES WMB/OCA-T1-1-4

WMB/OCA-T1-4

Please refer to footnote 44 on page 26. Please refer further to Tr. 2/184 where witness Ayub states, "I think [the penalty] is supposed to cover the transaction costs of pursuing the NSAs."

a) Is the cited statement from Mr. Ayub the entire basis of your estimate of litigation costs? If not, please explain fully the basis of your estimate

b) Please explain fully the basis of your assumption that the costs to negotiate an NSA are $250,000.

RESPONSE TO WMB/OCA-T1-4

(a) Yes.

(b) During discovery, I attempted to develop directly the Postal Service's costs related to the negotiation of the Washington Mutual NSA. As a result of the Postal Service's objection to my discovery request (see Objection of United States Postal Service to Interrogatory of the Office of Consumer Advocate to Witness Ayub (OCA/USPS-T1-28), July 10, 2006), however, I assumed negotiation costs of $250,000, based upon the work effort described in the testimony of witness Ayub, much of it occurring "[a]fter the commencement of negotiations with WMB." (Page 13). That work effort includes "extensive additional [Postal Service] research on the company using data from Postal Service systems and from publicly available sources." (Id.) The Postal Service work effort also involves considerable analysis "of a company's Before Rates forecasts," specifically analysis of volume trends, economic variables, account growth, and the company's response during negotiations, plus research and discussions with outside analysts. Moreover, the Postal Service's "process of evaluating WMB's forecast is an iterative process that continues through the course of our NSA negotiations." (Page 14) In addition, once negotiations have concluded, the agreement "undergoes a rigorous internal review process at the Postal Service, including review by a cross functional group of managers and executives." (Page 14-15) These elements—extensive additional research, considerable analysis, an iterative evaluation process, and rigorous management-executive review—formed the basis for my estimate.

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-5

WMB/OCA-T1-5.

Please refer to your response to WMB/OCA-T1-2(d) where you explain how cost savings "could be incorporated into the Panzar analysis." Please also refer to your response to WMB/OCA-T1-1(f) where you provide a Panzar analysis using a price-difference elasticity of -.8538. Finally, please refer to Table 4 on page 9 of WMB-T-1, which shows after-rates First-class Mail volume forecasts of 713 million, 750 million, and 785 million pieces, respectively, for Year 1, 2, and 3 of the NSA. For the purpose of this interrogatory, please assume that WMB's own-price elasticity for First-class Mail is zero

(a) Based upon a Panzar analysis that incorporates cost savings using the method described in your response to WMB/OCA-T1-2(d), what is the minimum price-difference elasticity that would result in a Year 1 USPS net benefit at an after-rates volume of 713 million First-class Mail pieces? Please provide all of your underlying calculations.

(b) Based upon a Panzar analysis that incorporates cost savings using the method described in your response to WMB/OCA-T1-2(d), what is the minimum price-difference elasticity that would result in a Year 2 USPS net benefit at an after-rates volume of 750 million First-class Mail pieces? Please provide all of your underlying calculations.

(c) Based upon a Panzar analysis that incorporates cost savings using the method described in your response to WMB/OCA-T1-2(d), what is the minimum price-difference elasticity that would result in a Year 3 USPS net benefit at an after-rates volume of 785 million First-Class Mail pieces? Please provide all of your underlying calculations.

RESPONSE TO WMB/OCA-T1-5

The "minimum" price-difference elasticities requested are unrelated to, and can only be derived separately from, the cost savings estimated by the Postal Service. The estimated cost savings from the provision of electronic address correction notices are calculated from Postal Service costs of providing electronic versus physical returns and a subset of Washington Mutual's after-rates volumes. As described in my response to WMB/OCA-T1-2(d), the Postal Service's estimated cost savings "would be added to the

'Net USPS Benefits',' which is estimated separately using a price-difference elasticity in the Panzar analysis.

As requested, however, the "minimum" price-difference elasticities can be derived from Washington Mutual's before-rates and after-rates point volume estimates for each year, the average revenue per piece for First-class Mail marketing letters and Standard Mail letters, and the agreement's negotiated discounts. Assuming Washington Mutual's own-price elasticity for First-class Mail marketing letters is 0, the form of the equation is

$$Q_0 = Q_1 \cdot 1 \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

where E, is the price-difference elasticity, Q and Q are Washington Mutual's before-rates (450, 475, and 500 million) and after-rates (713, 750, and 785 million) point volume estimates, respectively, for each year, d_0 is the before-rates average marginal price difference between First-class Mail marketing letters and Standard Mail letters ($0.346 - $0.206), and d, is the after-rates marginal price difference at the highest negotiated discount ($0.346 - $0.206 - $0.050), as provided in the testimony of witness Ayub (USPS-T-I), Appendix 1, Page 10, revised June 7,2006.

The "minimum" price-difference (i.e., "discount") elasticity, E,, the only unknown, can then be "backed-out" of the equation above by solving the following:

$$\ln Q_0 = \ln Q_1 + E_d \cdot \ln\left(\frac{d_0}{d_d}\right)$$

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-5

The "minimum" price-difference elasticities for each year, calculated in the attachment to this response, are presented below.

(a) Year 1: -1.0437

(b) Year 2: -1.0358

(c) Year 3: -1.0230

Attachment to the Response to WMB/OCA-T1-5(a) - (c)

"Price-Difference" (i.e., "Discount") Elasticity,
per USPS-T-1 (Ayub), Appendix A,
Page 10 (Rev 6-7-06)

			Year 1		Year 2		Year 3	
				Log (ln)		Log (ln)		Log (ln)
[1]	WMB BR Volume	Q_o	450	6.1092476	475	6.1633149	500	6.2146082
[2]	WMB AR Volume	Q_1	713	6.5694815	750	6.6200733	785	6.6656838
[3]	Ave Rev FCM Mkt Ltrs/pc		$0.346		$0.346		$0.346	
[4]	Std Rev/pc		$0.206		$0.206		$0.206	
[5]	BR Ave Price Difference, FCM - Std Mail	d_o	$0.140		$0.140		$0.140	
[6]	Discount (last tier)		$0.050		$0.050		$0.050	
[7]	AR Marginal Price Difference	d_1	$0.090		$0.090		$0.090	
[8]	Ratio BR / AR Price Difference		1.554189	0.440954	1.554189	0.440954	1.554189	0.440954
[9]	Natural Log			2.7183		2.7183		2.7183
	"Discount" Elasticity	E_d	$\boxed{-1.0437}$		$\boxed{-1.0358}$		$\boxed{-1.0230}$	

Sources:
[1] USPS-T-1, App A, Pg 2
[2] USPS-T-1, App A, Pg 2
[3] USPS-T-1, App A, Pg 10 (REV 6-7-06) unrounded
[4] USPS-T-1, App A, Pg 10 (REV 6-7-06) unrounded
[5] [3] - [4]
[6] USPS-T-1, App A, Pg 7
[7] [5] - [6]
[8] [5] / [7]
[9] Natural Log

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-6

WMB/OCA-T1-6

Please refer to the charts you provided in response to WMB/OCA-T1-1(f), which show that, assuming an own-piece elasticity of zero and a price-difference elasticity of -0.8538 and ignoring the NSAs cost savings, the NSA will generate a significant net change in USPS contribution in each year at WMB's After Rates volume forecasts.

Please also refer to interrogatory WMB/OCA-T1-5 and your response to it. Albeit in different words, WMB/OCA-T1-5 asked you how large WMB's price-difference elasticity would need to be for the NSA to generate a positive net change in USPS contribution each year at WMB's After Rates volume forecasts (713 million in Year 1, 750 million in Year 2, and 785 million in Year 3). You responded to this interrogatory by providing estimates of the price-difference elasticities implied by WMB's Before-Rates and After-Rates volume forecasts if one makes the additional assumption that WMB's own-price elasticity is zero.

Assuming that WMB's own-price elasticity is zero, how large, according to a Panzar Analysis, must the price-difference elasticity be for the NSA to produce a positive USPS net change in USPS contribution at WMB's After-Rates volume forecasts? Please provide your underlying calculations. If you are unable to incorporate the NSAs cost savings into the "Panzar Analysis," please indicate that this is so and ignore the NSAs cost savings in performing the Panzar Analysis.

RESPONSE TO WMB/OCA-T1-6

I interpret this interrogatory to request calculation of a price-difference elasticity assuming Washington Mutual enters First-class Mail solicitation letter volume that generates discounts equal to the estimated return cost savings of $2.2 million, $2.4 million, and $2.7 million at the stated after-rates volume of 713 million, 750 million, and 785 million, respectively, in Years 1, 2, and 3 of the agreement.

The following information is known: Washington Mutual's after-rates (i.e., 713 million, 750 million, and 785 million) volume estimate for each year, the average revenue per piece for First-class Mail solicitation letters (i.e., $0.346) and Standard Mail letters (i.e., $0.206), and the relevant negotiated discount (i.e., $0.035, $0.040, $0.045, or \$0.050). In the absence of a stated before-rates volume, however, a new before-rates volume must be calculated for each year of the agreement.

At the third declining block discount (\$0.045) tier, solicitation letter volume of 54 million, 58 million, and 65 million generate discounts equal to \$2.2 million, \$2.4 million, and \$2.7 million, respectively, during Years **1,** 2, and 3 of the agreement. This implies a new before-rates volume (or initial discount threshold volume) of 659 million (713 million – 54 million), 692 million (750 million – 58 million), and 720 million (785 million – 65 million) in Years **1,** 2, and 3, respectively.

Given the above information, and assuming Washington Mutual's own-price elasticity for First-class Mail marketing letters is 0, the form of the equation is

$$Q_0 = Q_1 \cdot 1 \cdot \left(\frac{d_0}{d_d}\right)^{E_d}$$

where E_d is the price-difference elasticity, Q_0 and Q_1 are the new before-rates (659, 692, and 720 million) and previously provided after-rates (713, 750, and 785 million) volume estimates, respectively, for each year, d_0 is the before-rates average marginal price difference between First-class Mail marketing letters and Standard Mail letters (\$0.346 - \$0.206), and d_1 is the after-rates marginal price difference at the relevant negotiated discount (\$0.346 - \$0.206 - \$0.045).

The price-difference (i.e., "discount") elasticity, E,, the only unknown, can then be "backed-out" of the equation above by solving the following:

$$\ln Q_0 = \ln Q_1 + E_d \cdot \ln\left(\frac{d_0}{d_d}\right)$$

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-6

The price-difference elasticities for each year, calculated in the attachment to this response at page 2, are presented the table below.

YEAR 1		YEAR 2		YEAR 3	
AR Volume	Elasticity	AR Volume	Elasticity	AR Volume	Elasticity
713 Million	-0.2035	750 Million	-0.2080	785 Million	-0.2233

It should be noted that the calculations presented above are not the Panzar analysis developed in my testimony, which estimates the increase or decrease in institutional contribution at each after-rates volume. Rather, the above calculations represent a variation of the "suggested framework developed by the Commission in PRC Op. MC2004-3 (Bank One Opinion and Further Recommended Decision), paras. 5001-5038. Washington Mutual's variation is the suggested use of its after-rates volumes to estimate a new before-rates volume — representing the difference between the after-rates volume and a volume that generates discounts equal to the return cost savings — and then calculating the resulting price-difference elasticity to judge whether the new before-rates volume is reasonable or not. As stated by the Commission:

> The Panzar analysis is not to be confused with the alternative approach model for designing declining block NSAs suggested by the Commission in its Opinion and Further Recommended Decision in MC2003-4, paras. 5001-38. The former is an analysis for evaluating the risk of loss, while the latter is a model for negotiating NSAs that uses the Panzar analysis in their design.

PRC Op. MC2005-3 (Bookspan), para. 4089, fn 110

Attachment to the Response to WMB/OCA-T1-6
Page 1

Threshold		Discount		Threshold		Discount		Threshold		Discount	
659,000,000	674,000,000	$	0.035	692,000,000	707,000,000	$	0.035	723,000,000	738,000,000	$	0.035
674,000,000	689,000,000	$	0.040	707,000,000	722,000,000	$	0.040	738,000,000	753,000,000	$	0.040
689,000,000	713,000,000	$	0.045	722,000,000	750,000,000	$	0.045	753,000,000	785,000,000	$	0.045
		$	0.050			$	0.050		-	$	0.050
-		$	0.050	-	-	$	0.050		-	$	0.055

Calculation of Discount Volume Where Discounts Equal Return Cost Savings

Return Cost Savings		**Year 1**		**Year 2**		**Year 3**
[1] Cost Saving	$	**2,200,000**	$	**2,400,000**	$	**2,700,000**
Discounts Earned						
[2] First tier ($0.035)	$	525,000	$	525,000	$	525,000
[3] Second tier ($0.040	$	600,000	$	600,000	$	600,000
[4] Third tier ($0.045)	$	1,075,000	$	1,275,000	$	1,575,000
[5] **Discounts**	$	**2,200,000**	$	**2,400,000**	$	**2,700,000**
Discount Volume						
[6] First tier		15,000,000		15,000,000		15,000,000
[7] Second tier		15,000,000		15,000,000		15,000,000
[8] Third tier		23,888,889		28,333,333		35,000,000
[9] **Volume**		**53,888,889**		**58,333,333**		**65,000,000**
[10] **Rounded**		**54,000,000**		**58,000,000**		**65,000,000**

Notes and Sources:
[1] USPS-T-1, at 31
[2] [6] * $0.035
[3] [7] * $0.040
[4] [1] - ([2] + [3])
[5] [2] + [3] + [4]
[6] 674,000,000 - 659,000,000; 707,000,000 - 692,000,000; 738,000,000 - 720,000,000
[7] 689,000,000 - 674,000,000; 722,000,000 - 707,000,000; 753,000,000 - 738,000,000
[8] [4] / $0.045
[9] [6] + [7] + [8]
[10] [9] Rounded to nearest million.

Attachment to the Response to WMB/OCA-T1-6
Page 2

"Price-Difference" (i.e., "Discount") Elasticity

			Year 1		Year 2		Year 3	
				Log (ln)		Log (ln)		Log (ln)
[1]	New WMB BR Volume	Q_a	659	6.4907236	692	6.539586	720	6.5792513
[2]	WMB AR Volume	Q_1	713	6.5694815	750	6.6200733	785	6.6656838
[3]	Ave Rev FCM Mkt Ltrs/pc		$0.346		$0.346		$0.346	
[4]	Std Rev/pc		$0.206		$0.206		$0.206	
[5]	BR Ave Price Difference, FCM - Std Mail	d_o	$0.140		$0.140		$0.140	
[6]	Discount (third tier)		$0.045		$0.045		$0.045	
[7]	AR Marginal Price Difference	d_1	$0.095		$0.095		$0.095	
[8]	Ratio BR / AR Price Difference		1.4725804	0.3870162	1.47258	0.3870162	1.47258	0.3870162
[9]	Natural Log			2.7183		2.7183		2.7183
	"Discount" Elasticity	E_d	$\boxed{-0.2035}$		$\boxed{-0.2080}$		$\boxed{-0.2233}$	

Sources:
[1] "Volumes" Worksheet, Line [10]
[2] USPS-T-1, App A, Pg 2
[3] USPS-T-1, App A, Pg 10 (REV 6-7-06) unrounded
[4] USPS-T-1, App A, Pg 10 (REV 6-7-06) unrounded
[5] [3] - [4]
[6] USPS-T-1, App A, Pg 7
[7] [5] - [6]
[8] [5] / [7]
[9] Natural Log

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMBIOCA-T1-7

WMB/OCA-T1-7.

Please refer to your response to WMB/OCA-T1-1(f) where you provide a Panzar Analysis for the WMB NSA using a price-difference elasticity of -.8538 and to the worksheet "Year 1" in the spreadsheet entitled Response_WMB-OCA-T1-1(f).xls

(a) Please insert -.35 into Cell D11 of the referenced Excel worksheet and confirm that, according to the resulting Panzar Analysis, if WMB's price-difference elasticity is -.35, then the WMB NSA will increase USPS contribution in Year 1 of the NSA at WMB's After-Rates volume forecast of 713 million First-class Mail pieces. If not confirmed. please explain fully.

(b) Please insert -.39 into Cell D11 of the referenced Excel worksheet and confirm that, according to the resulting Panzar Analysis, if WMB's price-difference elasticity is -.39, then the WMB NSA will increase USPS contribution in Year 2 of the NSA at WMB's After-Rates volume forecast of 750 million First-class Mail pieces. If not confirmed, please explain fully.

(c) Please insert -.44 into Cell D11 of the referenced Excel worksheet and confirm that, according to the resulting Panzar Analysis, if WMB's price-difference elasticity is -.44, then the WMB NSA will increase USPS Contribution in Year 3 of the NSA at WMBs After-Rates volume forecast of 785 million First-class Mail pieces. If not confirmed, please explain fully.

RESPONSE TO WMB/OCA-T1-7

For purposes of answering this interrogatory, I have used the unrevised Excel file, "Response–WMB-OCA-TI-1(f).xls," referenced in this interrogatory. See the errata notice filed this date concerning the revised response to WMB-OCA-T1-1(f).

(a) Not confirmed. Inserting the price-difference elasticity of -0.3400, rather than the provided price-difference elasticity of -0.35, into Cell D11 of the unrevised Excel file, "Response–WMB-OCA-TI-1(f).xls, worksheet "Year 1," will generate USPS contribution at the after-rates volume estimate *of* 713 million in Year 1 of the agreement.

(b) Not confirmed. Inserting the price-difference elasticity of -0.3875, rather than the provided price-difference elasticity of -0.39, into Cell D11 of the unrevised Excel file,

RESPONSE OF OCA WITNESS JAMES F. CALLOW
TO INTERROGATORY WMB/OCA-T1-7

"Response–WMB-OCA-T1-1(f).xls, worksheet "Year 2," will generate USPS contribution at the after-rates volume estimate of 750 million *in* Year 2 of the agreement.

(c) Not confirmed. Inserting the price-difference elasticity of -0.4330. rather than the provided price-difference elasticity of -0.44, into Cell D11 of the unrevised Excel file, "Response_WMB-OCA-T1-1(f).xls, worksheet "Year 3," will generate **USPS** contribution at the after-rates volume estimate of 785 million in Year 3 of the agreement.

See the Excel file, "Response–WMB-OCA-TI-7(a)-(c)," accompanying this response.

CHAIRMAN OMAS: Is there any additional written cross-examination for Witness Callow?

(No response.)

CHAIRMAN OMAS: There being none, this brings us to oral cross-examination.

Two participants have requested oral cross-examination, the United States Postal Service, Mr. Heselton, and Washington Mutual Bank, Mr. May.

Mr. Heselton, will you begin?

MR. HESELTON: Yes, Mr. Chairman.

CROSS-EXAMINATION

BY MR. HESELTON:

Q Good morning, Mr. Callow.

A Good morning.

Q Let me begin by seeing if we can summarize your testimony here as a starting point for oral cross-examination.

As I understand what you've done, you've taken Washington Mutual Bank's after rates volumes, and based on two assumptions you've derived a before rates volume. Is that correct?

A Yes.

Q And the first assumption in fact is that the own price elasticity is zero?

A Yes.

Q That's one of the assumptions. And this is based on Witness Rapaport's testimony that all of the new first class volume will be converted to standard volume. Is that correct?

A Correct.

Q Okay. And the second assumption is that **WMB's** shift from standard to first class is based on the price difference elasticity estimated by Witness Thress?

A Correct.

Q Now, since these elasticity effects are small, zero and about 0.1, the OCA calculation of before rates volume is very close to the after rates volume. Is that correct?

A When you say close --

Q As I recall, around 14 to 15 million or so.

A Out of a total of how much? We're talking about the difference.

Q Between in the first year 713 and 490 --

A Yes.

Q -- or 450 would be the before rates volume as estimated by WMB.

A Okay.

Q So your testimony would indicate that there's not an awful lot of response to this NSA. Is that correct?

A Based on the price elasticity, yes

Q This also means that the threshold is too low, and that before rates volume calculation implies that WMB would be sending most of the volume anyhow. Is that correct?

A Could you repeat the question?

Q Sure. What this also means is that the threshold in this NSA is too low and that the before rates volume calculation implies that WMB would be sending most of the volume anyhow because before and after rate volumes are very close.

A Yes.

Q And essentially this is the evidence that you've got in violation of the Panzar test. Is that correct?

A This is the evidence I developed from the Panzar test, yes.

Q What I'd like to do now is to take a look at the two elasticities that you've calculated. Let's start with the own price elasticity is zero. What is an own price elasticity?

A Can you refer me to my testimony, please, where you're citing?

Q Mr. Callow, I don't have a cite to your testimony in mind.

I'm picking up from the conversation we've had where we talked about the two assumptions underlying your testimony and the fact that one of these is an own price elasticity of zero. That's where I would just like to start the conversation.

We had agreed, hadn't we, that that was one of the two underpinnings of your calculations here?

A Yes.

Q And what I'm asking you here is with regard to your own price elasticity of zero calculation, how did you define own price elasticity?

A Change in quantity demanded. Percentage change in quantity demanded divided by percentage change in price.

Q Let's see if we can flush this out a little bit with use of a hypothetical.

Assume we have a gentleman who visits a butcher shop. Let's call him Mr. Meat Lover. He visits this shop on a rather regular basis, and when he goes into the shop he buys one pound of chicken. He pays $4. He buys one pound of steak. He pays $0. His total bill for one pound of chicken plus one pound of steak is $12. Do you have that hypothetical in mind?

A I'll try.

Q Now let's assume that he wanders into the butcher shop one day, and he finds that steak is on sale. Instead of $8, it's only $6. If you were looking at this situation as an economist, what might you expect Mr. Meat Lover to do under those circumstances?

Let me narrow it down for you, Might he increase his purchase of steak and decrease his purchase of chicken because the relative price difference between the two has been lessened?

A In your hypothetical, yes.

Q Yes. And so in this case let's assume in fact that what he does is he buys two pounds of steak at $6 each, the sale price. He buys no chicken at all. He puts down his $12 on the counter that he usually puts down, and he's done.

Now, in this case yocr analysis would indicate that the additional steak came from buying less chicken and so the own price elasticity here is zero in this case, is it not?

A Yes. This is consistent with the assumption of the Postal Service.

Q Let's see if we can move this hypothetical a little bit more toward the area of mail. Let's talk about standard mail instead of chicken and talk about first class mail instead of steak, and let's talk about WMB instead of Mr. Meat Lover.

Let's further assume that there's a difference between the first class rate and the standard rate of 12 cents. That's the price difference. That's the situation we start out with.

Now we want to adjust that price difference to something smaller as we did in the original hypothetical featuring Mr. Meat Lover. I face a little problem here. Have you ever seen a sale on first class mail?

A No.

Q It doesn't go on sals very often, does it, if ever?

A No.

Q And the same is true of standard mail, isn't it? There's not a sale on that that you've seen?

A **NO.**

Q Fortunately we have another way of narrowing the gap here. Let's assume that there's an increase in standard mail rates of five cents, so that gap between the price for first class and standard mail moves from a **12** cent gap to a seven cent gap.

Now, economic theory would suggest to us what kind of behavior by Washington Mutual Bank in these circumstances, a narrowing of this gap between standard mail and first class?

A Common sense would suggest you would get more standard mail. I'm sorry. You're talking about an own price elasticity?

Q Yes.

A Common sense would suggest you'd get more standard mail.

Q The price of standard mail in my hypothetical here has gone up.

A I'm sorry. I thought you said it went down from 12 to seven.

Q No. As I indicated in the hypothetical, I have a hard time building a hypothetical involving mail where the price of mail goes down.

We'd like to see it go that way, but usually it goes up, so what I've built into this hypothetical is an increase so we can have some way of narrowing the gap between the price for standard mail and first class mail in the hypothetical.

A Okay. All right.

Q And so if WMB's behavior follows that of Mr. Meat Lover, wouldn't they tend to buy less standard mail and buy more first class mail under these circumstances?

A Yes.

Q But they have a problem here, don't they, in that the price of standard mail has gone up and first class mail is more expensive, and so if they take their marketing budget they're not going to be able to buy as much first class mail as they don't buy of standard mail. Is that correct?

A If you hold their marketing budget constant, yes.

Q And I'm doing that in the same way that I held Mr. Meat Lover's budget constant at the $12.

So what we have here is another effect involved in own price elasticity which is an income effect. The problem that WMB finds is that now their marketing dollar doesn't go as far as it did before and so they cannot substitute first class mail for standard mail on a one-to-one basis, unlike what Mr. Meat Lover could do. Is that correct?

A Yes.

Q Therefore, their own price elasticity cannot be zero. Is that correct?

A Under your hypothetical, but that was not the model that was presented by the Postal Service, and that's not the model that I have. It's not in the financial model of the Postal Service or mine.

Q I understand your response. I'm simply trying to illustrate here how own price elasticity affects work through the use of the hypotheticals.

Let's turn now to the cross elasticity estimate of approximately 0.1. Now, that's the average elasticity of all the mailers in that category, is it not?

A I'm sorry. I'm not familiar with the cross price elasticity you're referring to.

Q Well, let's just identify that as the price difference elasticity as estimated by Witness Thress, the 0.1 that you took and incorporated into your analysis.

A All right. I recognize that.

Q That 0.1 represents, if you will, a cross elasticity measure that you've built into the analysis here.

A Well, I want to be clear. It's a price difference elasticity, which is different than a cross elasticity and demand. That was in response to T1-21 of the Postal Service.

Q Could you explain and summarize what that difference is?

A Yes. A cross elasticity of demand is a percentage change in quantity demanded of X divided by a percentage change in the price of Y, which would be another different product.

In the case of a price difference elasticity it's the percentage change in the quantity of X divided by a percentage change in the price difference between the price of Y and the price of X.

Q Let's see if we can work with both these definitions at the same time.

A Well, just to be clear, I did not use a price cross elasticity demand, and it's not something I'm going to be able to talk about because I didn't use it. It's not in my model, it's not in the Postal Service's model, and I didn't work with it.

Q That's fine. Let's just take what you did use and proceed from there.

What you did use represents, as I understand it, an average of the elasticities of all the mailers involved. Is that correct?

A It's an estimate of the mailers' elasticity.

Q And it could be made up of estimates of elasticities from a number of different mailers, is that correct, averaged together?

A Yes.

Q Let's take a look at the composition of particular groups of mailers that would make up this average, if you will.

You've got some mailers involved here who have no choice but to mail in the first class category. Is that correct?

A Yes.

Q And here we're talking about, to help you out here, that there are some kinds of materials, some kinds of content and so on that have to be mailed in first class as opposed to standard.

A Yes. Statement mail and so on.

Q And so those mailers have no choice but to mail in one category as opposed to the other?

A Correct.

Q Is that correct?

A Correct.

Q In fact, for perhaps different reasons you and I are among them. We probably don't mail very much in standard mail. Is that correct?

A I don't believe we can, so yes.

Q And the same would be true of small businesses that aren't involved in extensive advertising efforts. They're pretty much limited to mailing in first class?

A Yes.

Q And conversely we have some mailers down in third class mail who aren't likely to mail in first class. Is that correct?

To flush that out a little bit, there would be some mailers who are mailing advertising mail who get a bounce back rate on that mail that just keeps them in the business of mailing standard mail as part of their business.

They're not likely to go to first class mail because the economics aren't there to support it. Is that correct?

A Yes.

Q Now let's take a look at the situation that Washington Mutual Bank is in here. Focus particularly on Washington Mutual Bank's marketing piece volume as opposed to its operational or statement volume. Are you familiar with the distinction between these two types of mail?

A Yes.

Q Now, marketing pieces may be mailed either first class mail or standard mail, may they not?

A Yes.

Q And probably what determines or at least a major factor in determining which category of mail pieces are mailed in depends a lot on the return rate or the bounce back rate that the bank would get in one category of mail as opposed to the other, for example?

A Do you mean the response rate?

Q Response rate. That is correct? The response rate could be a factor?

A Correct.

Q In fact, perceptions are that the response rate might be higher in first class mail, which might encourage them to pay the higher rate so that they could get that kind of response. Is that correct?

A Yes.

Q What I'm getting at here is that Washington Mutual Bank has a real choice as to whether they mail in first class or standard mail this particular kind of material.

A The marketing mail, yes.

Q And so basically they're facing a situation here where they have mailing practices that permit them to mail in either category, the other category or both categories. Is that correct?

A Yes.

Q And so they're pretty far removed from the average in this case, aren't they, because the average includes a number of category of mailers that we've discussed who have no choice at all in terms of the category they mail in?

A Well, we know what the average is. We don't know what WMB's elasticity is.

Q That's not my question. My question is while we don't know what their elasticity is, we certainly can offer an opinion as to what their elasticity must be relative to the average in that group, can't we?

A I thought that's what I said. We don't know what their elasticity is, but it may or may not be different than the average.

Q Well, let's pursue that a little further, Mr. Callow.

If it's the case where we have a group here for which the average represents a number of mailers who pretty much have no choice in what category they mail in -- it's either first class or standard -- and then we have Washington Mutual Bank, which in fact does have a choice as to what category it mails in, doesn't in fact the elasticity have to be greater than that of the group as a whole just mathematically speaking?

A I guess common sense would suggest it would be different than the average.

Q And what you're saying is you don't know how different that is?

A Correct.

Q You have taken the average because you don't have another estimate?

A Correct.

Q Would you agree that depending on the composition of this group of mailers and the extent to which mailers don't have an opportunity to mail in first class as opposed to standard or in standard as opposed to first class that there could be a great deal of difference between the elasticity for Washington Mutual Bank, which has great flexibility, and the average?

A I guess at some point these mailers you're talking about have to represent and get factored into the average, so it would seem to me they can't -- if the average is made up of these mailers you're talking about, at some point the average has to represent them somehow, but a particular mailer may be different from the average.

Q Okay. What I'm suggesting here is that WMB has some characteristics to its mail that in fact suggest it is different than the average. Is that correct?

A Yes. We don't know what --

Q Let's move beyond the discussion of the two elasticity types that we've been discussing and talk about exogenous variables. What is an exogenous variable as you define it?

A In simple terms it's a factor outside the model, outside the pricing model. In more specific terms it would be therefore nonprice influences on demand.

Q In Footnote 18 on page 10 of your testimony where you reference the interrogatory response, in that footnote you quote from that response.

A Can you just hang on one second, please?

Q Certainly.

(Pause.)

A Yes.

Q Exogenous factors referenced there are things like other market conditions such as consolidation within the industry, lower response rates, legislative changes, market saturation, increases in postal costs and so on. Is that correct?

A Yes.

Q Let's see if we can flush out the role of exogenous variables here by use of another hypothetical. Let's assume that there is a mailer called City Group, and let's assume hypothetically that they mail about 1.5 billion pieces of marketing type mail.

Let's assume further that they just decide to not use mail at all in obtaining applicants for credit cards and so they drop their 1.5 billion pieces of mail. It goes to zero. Is this an exogenous factor, in your view?

A In your example you didn't mention any price, so it would be.

Q Yes, and I haven't mentioned price because in this particular example elasticities are irrelevant, aren't they? They're just no longer a player as a mailer.

A Yes.

Q Would City Group's exodus mailing from mailing the 1.5 billion pieces and dropping that volume to zero have an effect. cn postal finances, in your view?

A Yes.

Q That effect would be the loss of their contribution to the fixed costs of the Postal Service?

A Yes.

Q The burden of these fixed costs would then be shifted to other categories of mail?

A Yes.

Q Let's move from that example, the exogenous variable, to possibly another one.

The Washington Mutual Bank NSA requires that WMB convert 90 percent of its standard marketing mail to first class mail before incentives kick into effect. Is that correct?

A Yes.

Q And this in fact is an unprecedented clause in an NSA at this point. This is the first one. Is that correct?

A I believe that's true.

Q And this would be an exogenous variable in your analysis, would it not?

A Yes. It's a contract provision.

Q Yes. In fact, it doesn't make any difference what Washington Mutual Bank's elasticities are. In order to play in this NSA they have to convert. Is that correct?

A They have to convert, yes.

Q And if Washington Mutual Bank doesn't convert, it can't be part of this NSA. Basically instead of looking at elasticities they're either in this NSA or they're out. Is that correct?

A They're making a business decision either to play or not play, yes.

Q And the Panzar approach isn't particularly helpful in dealing with this particular situation because this is an exogenous variable to that process. Is that correct?

A It excludes exogenous variables.

Q Let's take a look now and see what we can say about the risk in this NSA to the Postal Service and to Washington Mutual Bank because I take it that one feature of the Panzar approach is that it is a device that might be used in certain situations to calculate what the risks are. Is that correct?

A It's used to estimate the loss to the Postal Service at certain volumes, after rates volumes.

Q Well, in fact in this particular case the Postal Service can't help but come out ahead, can it? That's assuming that Washington Mutual Bank does want to participate in this NSA.

A That's not true.

Q And why is that not true?

A Because if you use the average elasticity there are volumes at which the Postal Service will generate a loss.

Q Well, I was simply going to indicate here that we've already been over the use of average elasticities, and we've already I thought agreed that

Washington Mutual Bank isn't looking at an average elasticity here. Let's move beyond that.

A Except that the elasticity -- if the Postal Service or Washington Mutual has an elasticity that's different than the average it doesn't mean the Panzar analysis is irrelevant.

It means that the volume at which the loss would occur or, stated positively, the range of volume over which there will be a positive contribution may be larger or smaller, depending upon the elasticity. It doesn't mean the Panzar analysis itself is inadequate.

Q Let's pursue that. When Washington Mutual Bank converts at least 90 percent of its standard mail to first class mail, that is going to result in an increased contribution for the Postal Service, is it not?

A It depends on if it's an exogenous variable. Let me back up. We can estimate from the conversion what the after rates volume -- using the after rates volume or the actual volumes, an estimate of actual volumes, we can estimate where the range of volumes over which there's a positive contribution.

Q Let's see if we can take this on a piece by piece basis. Washington Mutual takes one piece of standard mail and converts it to a piece of first class mail. The contribution is higher for which category of mail to the Postal Service?

A The contribution is higher in the first class mail piece.

Q And so a conversion from standard to first class mail results in an increase of contribution for the Postal Service? Is that what your answer indicates?

A It's on the range of volumes. When you apply the elasticity, you get a range of volumes over which you can determine the range of volumes that generates a positive contribution. Within that range is the contribution, so in effect you can go from zero to zero.

Q Well, here I'm looking at the obligation of Washington Mutual Bank to take 90 percent of its standard advertising mail and convert that to first class mail.

The net effect of that would be an increase in contribution to the Postal Service, would it not? Mathematically speaking, it has to work out that way. Isn't that true?

A No, because under the Panzar analysis there's a volume at which there will be -- not all volume generates a contribution using the average elasticity.

Q Mr. Callow, what we're looking at here is an obligation on Washington Mutual Bank that goes beyond the Panzar analysis. This is an exogenous variable we're looking at here. Is that correct?

A Yes.

Q And so I'm looking at here taking that variable apart from the Panzar analysis, which does not apply to this particular facet.

I'm looking at the effect of that conversion of 90 percent of Washington Mutual Bank's standard mail to first class mail, and I'm indicating to you that doesn't that mean contribution from that mail has to be higher for the Postal Service after this NSA is implemented than before?

A If you can tell me after rates volume I can apply the elasticity to that volume and tell you whether there is a contribution or not.

Q Well, the contract provision requires that they bring over and convert volume from standard to first.

A What that volume is will depend on what that volume is when applied -- when the elasticity is applied to it will determine whether the agreement as a whole generates a contribution. On an individual basis piece-by-piece it may, but not in total.

Q Well, I'm trying to focus here on this one portion of the NSA, this one aspect of the NSA.

A Okay.

Q Admittedly a very major aspect of this NSA. Focusing only on this conversion by Washington Mutual Bank, this requirement that's exogenous to the Panzar analysis that they convert 90 percent at least of advertising mail that's now going standard mail into advertising mail going at first class rates, that that conversion in and of itself bas to provide a positive net benefit to the Postal Service in the form of increased contribution.

A Not necessarily. If you tell me the after rates volume I can tell you whether there's a positive contribution.

Q Well, what I'm postulating here is that their after rates volume is the same as their before rates volume in effect because they're mailing the same number of pieces after on this conversion that they did before, Mr. Callow.

Under those circumstances, would there be an increase in contribution to the Postal Service?

A I don't know. If you can tell me a volume, I can tell you a contribution. I can tell you whether it will generate a positive contribution using the price elasticity.

MR. HESELTON: Mr. Chairman, the Postal Service has no further cross-examination.

CHAIRMAN OMAS: Thank you, Mr. Heselton.

Mr. May?

CROSS-EXAMINATION

BY MR. MAY:

Q Good morning, Mr. Callow. If you would refer to page 21 of your testimony, lines 7 through 16?

A I have it.

Q There you indicate that you propose that the Commission only allow WMB to claim discounts on first class mail going up to either 521 million or 544 million pieces of first class mail per year. Is that correct?

A That is correct.

Q And because the discount threshold is 490 million, your proposal is for WMB to receive discounts on between 31 and 54 million pieces above the threshold, right?

A Yes.

Q And while I don't want to yo through all of the details of how you derived these figures, is it fair to say that the Panzar analysis, which is illustrated in the charts on pages 18 through 20, provides the foundation for your proposed caps? Is that right?

A Yes.

Q Now, that analysis shows that the Postal Service will lose money from the deal if WMB mails more than 550 million pieces of first class mail. Is that correct?

A That's correct.

Q And you propose therefore to cap the discount at a lower volume because you want the Postal Service to do better than just break even?

A That's correct.

Q But fundamentally your caps are based upon the Panzar analysis shown on pages 18 to 20, right?

A That's correct.

Q Now, you had to make some assumptions to perform the Panzar analysis, and I believe you went through some of those with the Postal Service. I just want to talk about one of them, the price difference elasticity that you used.

A Yes.

Q Okay. Now, the price difference elasticity

I think you've discussed is a measure of the sensitivity of a mailer's first class volume to the price difference between first class mail and standard mail. Is that correct?

A Yes.

Q Now, in performing your analysis you assumed that WMB's price difference elasticity is equal to the subclass average Mr. Thress testified to, which is a negative .1115. Is that right?

A That is correct.

Q Now, that means that if the price differential between first and standard was reduced or changed by one percent then first class mail volumes would also change by one-tenth of one percent roughly. Is that correct?

A Yes.

Q Or to expand it, if there were a 10 percent change in price then there would be a corresponding one percent change in volume?

A Yes.

Q Okay. Now I'd like you to refer to WMB's question to you, Question 1, and see if you would agree that the OCA there backed out, to use your words, a WMB specific price differential elasticity of minus .8538 by using WMB's before rates and after rates volume forecast, assuming that WMB's own price elasticity is zero, That is what you undertake there, is it not?

A I believe. Are you referring to part (e)?

Q Yes. And I believe the Postal Service in its answer to you in 29(d) confirmed your calculations as being a correct calculation, again assuming that the price difference elasticity is minus .8 and not minus .l.

A Correct.

Q And you calculated this .8, but assuming that WMB was correct when it testified what its after rates volumes would be, because that's how you backed out or derived a price difference elasticity using their estimates of volume change.

A Yes, and the average revenue for first class marketing letters and standard mail.

Q Right.

A Correct.

Q Okay. So if one were to believe or the Commission believes Mr. Rapaport's projection of the increases in volume that his company will adapt if there are these price discounts, if the Commission believes Mr. Rapaport then the correct price difference elasticity to be used in the Panzar analysis would be the negative .8538. Is that correct?

A Yes. Based upon the volumes, the after rates and before rates volumes that were presented by WMB, yes.

Q But if the Commission believes their testimony is correct for various reasons then that would be the proper elasticity to put into the Panzar analysis. I think you've agreed to that, correct?

A If you believe their after rates, before rates and after rates volumes.

Q Yes. Now, you provided a Panzar analysis using a price difference elasticity of negative .8538 in your response to WMB's Question 1(f), did you not?

A Yes. Just one second, please.

Q Yes.

A Yes. It only used minus .8538.

Q Now, I believe the change you made in that answer is that the revised Panzar analysis is based on cost and revenue data from Mr. Ayub's initial testimony, correct?

A That is correct. That is the only change I used.

Q Okay. So you made this revision which was introduced today --

A Yes.

Q -- because the negative .8538 was calculated using the revenue from Mr. Ayub's initial testimony?

A That's correct, because at the time the interrogatory to Mr. Ayub was filed we only had the price data from his original testimony.

Q Now, that Panzar analysis that you hopefully performed is in the record.

Let me ask you again. If the Commission believes Mr. Rapaport's projections of volume after rates then that's the Panzar analysis that the Commission should use?

A If they believe it, yes.

Q Thank you. Now I'd like to discuss a little bit your revised response that 'we've just discussed. I'd like you to take a look at the charts that you provided in response to this interrogatory.

A Are you referring to 1(f)?

Q Yes, I am.

A Thank you.

Q Now, if you'll look at those charts, and I know I'm asking you to kind of eyeball this, but, for example, based on this Panzar analysis you've done about how much money will the Postal Service make in year one if WMB mails 713 million pieces? You can just go along the bottom and then go up.

A Just to eyeball it, somewhere around $16 million possibly.

Q Yes. Would using a ruler to trace that help you?

A NO.

Q Okay.

A That's fine. I mean, I've got other things here.

Q Fine. Again, in year two? If WMB mailed 750 million pieces, again how much profit would the Postal Service make in year two?

A Approximately **$15.5** million.

Q Thank you. And again in year three? If they mail **785** million pieces, again what would be the profit to the Postal Service out of that deal?

A Roughly **$15.4**, $15.3 million maybe.

Q Fine. So according to this analysis, the Postal Service will make between **$45** and **$50** million from this deal if **WMB's** mail volumes are as forecast and if the negative .8538 price difference elasticity is accurate? Is that not correct?

A Yes.

Q Now, these figures completely ignore any cost savings that would result from the deal; for example, the cost savings because of getting electronic return instead of physical return of their undeliverables, so there is that savings as well? They're not quantified, but there is that savings?

A Well, they're not quantified in the model --

Q That's right.

A -- of the Postal Service or in the charts presented here.

Q So those savings, whatever they're worth, would be in addition to this $45 to $50 million profit the Postal Service would make if WMB's volume forecasts were correct?

A If those are to be included, yes.

Q Yes. And do you remember what the basis of Mr. Rapaport's after rates volume forecast was?

A I'm sorry. Do I remember what the volume estimates were?

Q What the basis for it was.

A I believe it was the testimony of WMB Witness Rapaport.

Q Yes. On page 8 of his testimony, if you'd Like to refresh your recollection of his testimony --

A Are these the after rates volumes?

Q Yes. I believe you'll see there in his testimony he said he came up with this volume forecast and performed a break even analysis, break even for the company, of converting standard to first by using WMB's targeting engine so-called.

A Yes.

Q And WMB did provide under protective conditions and at the request of the Commission documentation of its targeting engine and how WMB used that engine to estimate after rates volume?

A That's my understanding.

Q All right. I'd like to refer you to your response to WMB/OCA-T1-7.

A I have it.

Q Am I correct that your response to this interrogatory indicates that the Postal Service will make money on the deal at WMB's forecasted mail volumes even if WMB's price difference elasticity is much smaller than .8538?

A Yes.

Q Now, in your response to that interrogatory you indicate that you used the unrevised version of the OCA-T1-1(f) model to respond to our question.

Would your response to that question be much different if you had used the updated version of OCA-T1-1(f) that you filed today?

A It would be different, but I can't recall how different because I was focused on this, getting it right.

Q Well, let me ask you. Could it be, let us say, that the elasticity could be only half as much as the .8?

A I don't know.

Q Well, if it were only half as much would the Postal Service still make money?

A I don't know.

Q Well, you did make that calculation using the original numbers. That's what we asked you to confirm.

A On the minus .85. I'm sorry. I'm not following you now.

Q What we had asked you and you responded yesterday was to the question of in effect to ask you to confirm whether an elasticity that was less than half the .8 elasticity implied by WMB's forecast, we asked you even if the elasticity was only half of that and provided you with a specific number and asked you could you confirm that at that rate, even at that lower rate, the Postal Service would make a profit.

A Yes. In year one, minus .34.

Q Thank you. I believe you said in year two the Postal Service would make money if the price difference elasticity was just minus .3875, correct?

A Correct.

Q And in the third year, the same circumstances. They would make money even if it was only minus .4330, correct?

A Correct.

Q One other thing. If you could go back to your Figure 1 on page 18 of your testimony?

A I have it.

Q I'd like to ask you why *you* have this arrow pointed at the number **500** million. It says Volume Guaranteed.

A Yes.

Q Shouldn't that arrow really be at **620** million?

A NO.

Q Let me ask you. Are you aware that they have to mail **120** million pieces of first class mail because it's statement mail or customer mail that has to go first class?

A Yes, but the penalty --

Q No. I'm talking about the guarantee. The guarantee is to mail on top of that 120 million **500** million more pieces of first class solicitation mail, and if you add the **120** to that **500** that puts their obligation, the mail they're going to have to mail because they have to mail 120 million first plus another 500 million, that brings you to 620 million.

That's the minimum amount of mail they have to make or they'll be in violation of this deal.

A That's not my understanding. My understanding is at Footnote 25 on page 12 of my testimony --

Q Yes?

A -- where it says according to Witness Ayub Article 2, paragraph J, of the NSA commits WMB to mailing the lesser of 500 million --

Q Solicitation mail.

A -- first class solicitation mail or 90 percent of total marketing mail.

Q Right. So the arrow marks the lesser? Well, that 500 million wouldn't be the lesser, would it, unless they just stopped marketing altogether?

A I don't know at this point. I think I'd have to review this.

Q Well, let me follow up with that a little. Let's assume that because of the amount of marketing they have to do to stay in business that the 500 million is less than 90 percent of all of their marketing mail. Let's assume that.

If that's correct then they are going to have to mail 620 million pieces or they're going to be in violation of the agreement. Actually it could be a little more because in fact WMB's operational mail volumes are projected at 125 to 130 million pieces, but at a minimum 120 million.

Now, the discount caps that you were proposing -- that is between 520 million and 544 million pieces -- are well below the first class mail volumes that WMB would have to mail in order to meet the condition of the agreement. Isn't that correct?

A I don't know if that's true.

Q Well, I've asked you to assume that the 500 million is the lesser of that or 90 percent of their marketing mail.

Now, obviously if they get out of the business of marketing then 90 percent of nothing is zero and so that would be the lesser, but if they're going to stay in business -- most of their business they get through the mail -- then how are they going to stay in business if they don't continue to increase their marketing?

I'm asking you assume that the 500 million is the minimum amount of first class solicitation mail the agreement requires them to send, plus we know they have to by law mail another 120 to 130 million pieces of statement mail, the kind of mail that they're obligated to send to their customers and that can only be mailed first class.

That brings you to 620 or 630 million, does it not, or is something wrong with my math?

A Your math is fine.

Q Fine. So then the gap between the 620 to 630 million they have to mail to comply with this deal and the discounts you would give them on up to 540 million, that leaves them about 90 pieces of first class mail that you would not give them a discount on, but that they are required to mail. Isn't that correct? You wouldn't give them the discount on that 90 million, would you?

A Based upon your math, yes.

Q Pardon me?

A Based upon the math you're giving me.

Q Now let me ask you this. What was their projection of before rates first class volume?

A In year one?

Q Yes.

A Four hundred and fifty million.

Q That's correct. They don't get a discount, so in order also to get to the threshold, 490 million, they're going to have to mail the first 40 million pieces with no discount because they only start getting a discount over 490 million.

So they have to mail 40 million pieces to get to the 490 million, and then they have to mail another 90 million pieces of first class mail that are over and above the threshold you would allow them to get discounts on, bringing that, according to my math again, to they will have to mail 130 million pieces of first class mail upon which they get no discount whatsoever.

I believe if you calculate your total discounts you would give them, I think it comes to around $2 million in even numbers in year one. Is that correct?

A I believe that's correct.

Q Yes. I've just calculated that out. You know, that's only about one cent.

If you average that amount of money over all of the volume they have to send to get from 450 million up to the 630 million, if you divide that that ends up as being a discount on average for all the additional mail of one cent apiece, so they would have had to mail this additional first class mail volume upon which it's costing them 10 cents more at least than standard mail.

That mail would cost them $10 to $12 million more to mail, and you want to give them a discount of $2 million. Now, who would sign that deal? Would you as a businessman make a deal that said you were going to have to spend an additional $10 million, and all you were going to get back for it was $2 million in discounts? Who would make that deal?

A I don't know.

Q In other words, your proposal kills any possibility of this deal, doesn't it, unless they're out of their minds and don't care whether they lose money?

A (Non-verbal response.)

MR. MAY: That's all I have, Mr. Chairman

CHAIRMAN OMAS: Thank you, Mr. May.

Is there any additional participant who would like to cross-examine Witness Callow?

(No response.)

CHAIRMAN OMAS: Are there any questions from the bench?

(No response.)

CHAIRMAN OMAS: Is there any follow-up cross-examination from the bench?

(No response.)

CHAIRMAN OMAS: No. None. They didn't ask any.

Mr. Costich, would you like some time with your witness?

MR. COSTICH: Yes, Mr. Chairman. Could we have about 10 minutes?

CHAIRMAN OMAS: Fine. We'll come back at 10:45.

(Whereupon, a short recess was taken.)

CHAIRMAN OMAS: Mr. Costich?

MR. COSTICH: Thank you, Mr. Chairman.

REDIRECT EXAMINATION

BY MR. COSTICH:

Q Mr. Callow, I'd like to pose a hypothetical to you.

I'd like you to assume that there is a neighborhood butcher shop that sells beef and chicken. It sells beef for $8 a pound and chicken for $4 a pound, It has a customer names Mr. Meat Eater who goes to the butcher shop once a week and buys one pound of beef for $8, one pound of chicken for $4, spends a total of $12.

I'd also like you to assume that Mr. Meat Eater only likes beef, and the only reason he buys chicken is because his wife likes chicken. One week his wife is out of town. He goes to the butcher shop and spends his entire $12 budget on beef.

It so happens on that particular week there's a sale on beef. It's no longer $8 a pound. It's $6 a pound. Observing Mr. Meat Eater spends his entire $12 on beef, would we assume that he did so because the price had been reduced from $8 to $6?

A Not necessarily. In your hypothetical, he doesn't need to buy chicken. His wife is out of town, and he doesn't like beef. He doesn't like chicken. I'm sorry.

Q If we can bring this back to the WMB NSA, is there any way for you to know whether WMB would have converted its standard mail to first class in the absence of an NSA?

A There's no way to know, but there may be reasons other than the NSA for doing so.

For example, Capital One used first class mail before it had an NSA. Apparently it found the first class mail effective for its business purposes. There might be competitive reasons or changes in the competitive environment that might be a reason.

MR. COSTICH: Thank you. No further questions.

CHAIRMAN OMAS: Is there any additional?

Mr. Heselton? Questions? Mr. May?

MR. MAY: Yes.

RE-CROSS-EXAMINATION

BY MR. MAY:

Q This fellow who goes to the shop, his wife is out of town. He usually buys $8 worth of beef. Why would he buy any more beef the next week unless he was responding to a price?

His wife isn't home. What, he's going to eat twice as much beef now? Otherwise why does he need this additional beef unless he's responding to the cut in the price?

A He has a total budget of $12 that he's purchasing beef with.

Q Do you mean he's going to buy beef he won't be able to eat?

A Not necessarily.

Q When will he eat it, the following week when his wife comes back, and then he won't have to buy beef that week? Is that what you're saying, or he's going to eat twice as much beef while his wife is away?

A I guess that would be possible.

MR. MAY: That's all, Mr. Chairman.

CHAIRMAN OMAS: Is there anyone else who

would like to cross-examine Witness Callow?

(No response.)

CHAIRMAN **OMAS**: There being none, Mr. Callow, that completes your testimony here today. We appreciate your appearance and your contribution to our record. You are now excused.

THE WITNESS: Thank you, Mr. Chairman.

(Witness excused.)

CHAIRMAN OMAS: Thank you all for being here today. That concludes today's hearings. Thank you.

(Whereupon, at 10:54 a.m. the hearing in the above-entitled matter was concluded.)

//

//

//

//

//

//

//

//

//

//

//

//

//

364

REPORTER'S CERTIFICATE

DOCKET NO.: MC2006-3

CASE TITLE: Washington Mutual Bank NSA

HEARING DATE: 10/11/06

LOCATION: Washington, D.C.

I hereby certify that the proceedings and evidence are contained fully and accurately on the tapes and notes reported by me at the hearing in the above case before the Postal Rate Commission

Date: 10/11/06

Official Reporter
Heritage Reporting Corporation
Suite 600
1220 L Street, N.W.
Washington, D.C. **20005-4018**